# CORPORATION FOR SMALL BUSINESS INVESTMENT

## HEARINGS

BEFORE THE

SUBCOMMITTEE ON SBA AND SBIC AUTHORITY, MINORITY ENTERPRISE AND GENERAL SMALL BUSINESS PROBLEMS

OF THE

## COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

SECOND SESSION

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WASHINGTON, DC, JUNE 24 AND 25, 1986

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Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE

65-919 O WASHINGTON : 1987

For sale by the Superintendent of Documents, Congressional Sales Office
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# CORPORATION FOR SMALL BUSINESS INVESTMENT

TUESDAY, JUNE 24, 1986

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON SBA AND SBIC AUTHORITY, MINORITY ENTERPRISE AND GENERAL SMALL BUSINESS PROBLEMS, COMMITTEE ON SMALL BUSINESS,

*Washington, DC.*

The subcommittee met, pursuant to notice, at 10 a.m., in room 2359-A, Rayburn House Office Building, Hon. Parren J. Mitchell (chairman of the subcommittee) presiding.

Mr. MITCHELL. Good morning. Our hearing will now resume. The hearing today is on a proposal to create a Corporation for Small Business Investment [COSBI] and to transfer the SBIC and MESBIC Programs currently administered by the Small Business Administration to the corporation.

The idea has been on the drawing board for a very long period of time. It is the idea of privatizing the SBIC and the MESBIC programs. Apparently, there is good support in the small business community for this and, as I understand it, the administration also supports it.

In consideration of the time, I will just submit my entire opening statement for the record.

OPENING STATEMENT OF CHAIRMAN MITCHELL

Today we are resuming hearings on a proposal to create a corporation for small business investment (COSBI), and to transfer the SBIC and MESBIC programs currently administered by the Small Business Administration [SBA] to the corporation.

This concept has been on the drawing boards for several years and has been the subject of a number of revisions. Most recently it was contained in H.R. 3484 which was the subject matter of hearings last December. Since then, the bill has been tightened and improved.

On June 12, 1986, along with thirty-six of my Small Business Committee colleagues, I introduced the revised legislation as H.R. 5019.

This bill still carries forward the basic theme of privatizing the SBIC and MESBIC programs, a goal supported by the small business community and the administration. The revisions do, however, provide greater protection to the government and to the small business which have been or will be assisted with their venture capital needs.

The legislation would establish a federally chartered but privately owned Corporation for Small Business Investment [COSBI] which would be operated by a permanent board of directors of fifteen members (ten being elected by the shareholders and five being appointed by the President). Existing licensees or new companies who wish to affiliate with COSBI would be required to purchase stock in the corporation in an amount equal to 2 percent of their private capital and any increase therein; those existing licensees not electing to affiliate with the new corporation would go out of existence within two years after the repayment of any outstanding deben-

tures guaranteed by SBA, and SBA would cease having regulatory authority over the SBIC/MESBIC industries.

COSBI would obtain and purchase the outstanding portfolio of SBIC debentures guaranteed by SBA and now held by the Federal Financing Bank (about $1.1 billion). COSBI would obtain capital to provide to its shareholders by issuing securities to private investors. This COSBI paper would not be federally guaranteed, although its issuance would be subject to the approval of the Secretary of the Treasury. In addition, in his discretion and subject to the appropriation of funds, the Secretary of the Treasury, as a backstop, would be authorized to purchase up to $500 million in COSBI paper.

In order to promote and assist minority small businesses, a MESBIC type trust (governed by five trustees) would be established within the corporation. The trust would be funded by transferring to it the existing portfolio of MESBIC debentures and preferred stock which SBA now holds (about $275 million), along with $100 million from the sales proceeds of the SBIC debentures. The trust would provide debenture subsidies to and purchase preferred stock from special SBICs, i.e., those who provide assistance to socially or economically disadvantaged small businesses. The trust would terminate in fifty years, at which time its assets would be given to the Secretary of the Treasury.

Today we will hear from SBA and private witnesses and tomorrow we will hear from representatives of the SBIC and MESBIC industries.

[The bill H.R. 5019 follows:]

99TH CONGRESS
2D SESSION

# H. R. 5019

To amend the Small Business Investment Act of 1958 to create the Corporation for Small Business Investment, to transfer certain functions of the Small Business Administration to the Corporation, and for other purposes.

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IN THE HOUSE OF REPRESENTATIVES

JUNE 12, 1986

Mr. MITCHELL (for himself, Mr. MCDADE, Mr. SMITH of Iowa, Mr. GONZALEZ, Mr. LAFALCE, Mr. BEDELL, Mr. NOWAK, Mr. LUKEN, Mr. SKELTON, Mr. STENHOLM, Mr. MAVROULES, Mr. HATCHER, Mr. WYDEN, Mr. ECKART of Ohio, Mr. SAVAGE, Mr. ROEMER, Mr. SISISKY, Mr. TORRES, Mr. COOPER, Mr. HAYES, Mrs. LONG, Mr. CHAPMAN, Mr. ROBINSON, Mr. CONTE, Mr. BROOMFIELD, Mr. IRELAND, Mr. HILER, Mr. WEBER, Mr. DREIER of California, Mr. KOLBE, Mr. COBEY, Mr. COBLE, Mr. DIOGUARDI, Mr. GALLO, Mr. MCMILLAN, Mr. MCKINNEY, and Mr. COMBEST) introduced the following bill; which was referred to the Committee on Small Business

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# A BILL

To amend the Small Business Investment Act of 1958 to create the Corporation for Small Business Investment, to transfer certain functions of the Small Business Administration to the Corporation, and for other purposes.

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,* That this Act may be cited as the "Corporation for Small Business Investment Charter Act".

SEC. 2. Section 103 of the Small Business Investment Act of 1958 (15 U.S.C. 662) is amended—

(a) by inserting before the semicolon in paragraph (3) the following: ", or a company qualified to conduct business with the Corporation under section 357 of this Act";

(b) by inserting before the semicolon at the end of paragraph (5) the following: ", except that for purposes of title III the term means one which, together with its affiliates, is independently owned and operated, is not dominant in its field of operations and—

"(A) does not have net worth in excess of $7,000,000 and does not have an average net income, after Federal income taxes, for the preceding two years in excess of $2,500,000 (average net income to be computed without benefit of any carryover loss), except that such net worth and net income limitations shall be adjusted effective January 1 of each year following the effective date of this Act. Each such adjustment shall be made by adding to each such amount (as it may have been previously adjusted) a percentage thereof equal to the percentage increase during the twelve-month period ending with the previous October in the implicit price deflator for gross na-

tional product published by the United States Department of Commerce, with 1986 being the initial year for adjustment; or

"(B) otherwise qualifies under size standards for financial assistance established by the Administration under the Small Business Act, as amended (Public Law 163, Eighty-third Congress).".

(c) by striking "and" at the end of paragraph (7);

(d) by striking the period at the end of paragraph (8) and inserting in lieu thereof a semicolon; and

(e) by inserting after paragraph (8) the following new paragraphs:

"(9) the term 'Corporation' means the Corporation for Small Business Investment, as constituted under this Act; the Corporation shall be classified as and considered to be a corporate instrumentality of the United States;

"(10) the term 'Board of Directors' means the Board of Directors of the Corporation;

"(11) the term 'disadvantaged small-business concern' means a small-business concern owned by a person or persons whose participation in the free enterprise system is hampered because of social or economic disadvantages;

"(12) the term 'law' includes any law of the United States or any State (including any rule of law or of equity);

"(13) the term 'organization' means any corporation, partnership, association, business trust, or other business entity;

"(14) the term 'security' has the meaning ascribed to it by section 2(1) of the Securities Act of 1933 (15 U.S.C. 77(b)(1));

"(15) the term 'small business investment security' shall include—

"(A) debentures, bonds, promissory notes, obligations or securities issued by small business investment companies, and

"(B) such other small business investment company securities as determined by the Corporation;

"(16) the term 'private capital' means the combined private paid-in capital and paid-in surplus of a corporate small business investment company, or in the case of an unincorporated small business investment company, the permanent partnership capital; and

"(17) the term 'licensee in good standing' means a small business investment company which was approved by the Administration to operate under the pro-

visions of this Act and was issued a license as provided in section 301 of this Act, unless such licensee (A) is in default under the provisions of preferred securities or debentures and such preferred securities or debentures have been declared due and payable by the Administration, or (B) is in liquidation by the Administration for regulatory reasons.".

SEC. 3. Title III of the Small Business Investment Act of 1958 is amended by adding the following new section at the end thereof:

"TRANSFER AND PHASEOUT

"SEC. 322. (a) A licensee in good standing shall have a period of three months from the date the Administration receives notice under section 352(h) of this Act in which to qualify under section 357(a) or section 359(a) of this Act.

"(b) Within six months after the Administration receives notice under section 352(h) of this Act, the Administration shall promulgate final rules and regulations to effect the orderly termination of operations of any licensee in good standing that is not qualified under section 357(a) or section 359(b) of this Act, and the Administration shall enter into an agreement with the Corporation which provides for the administration of such rules and regulations by the Corporation.

"(c) The final rules and regulations adopted by the Administration for termination of the operations of any licensee under subsection (b) of this section shall, among other things,

suspend such licensee's authority under this Act to obtain financial assistance from the Administration and shall require revocation of the license of any such licensee effective within two years after the publication of such rules and regulations, except that the license revocation for any such licensee which has outstanding debentures or preferred securities as provided in this Act shall be within two years after such debentures or securities are due or paid, whether voluntarily or otherwise.

"(d) The Administration shall furnish to the Corporation all books and records of the Administration necessary to carry out the provisions of this Act within thirty days after written request by the Corporation unless the Administrator certifies to the Corporation that such books and records are not available within such time, provided that the Administration shall not furnish information on any individual licensee unless the licensee has entered an agreement for the release of such information. Any such information received by the Corporation shall be kept confidential by the Corporation, its officers, agents and employees, under the same provisions which would have been applicable if it had been retained by the Administration.".

"SEC. 4. Title III of the Small Business Investment Act of 1958 is amended—

(a) by amending the table of contents to read as follows:

"TITLE III—SMALL BUSINESS INVESTMENT COMPANIES

"PART A

"Sec. 301. Organization of small business investment companies.
"Sec. 302. Capital requirements.
"Sec. 303. Borrowing power.
"Sec. 304. Provision of equity capital for small-business concerns.
"Sec. 305. Long-term loans to small-business concerns.
"Sec. 306. Aggregate limitations.
"Sec. 307. Exemptions.
"Sec. 308. Miscellaneous.
"Sec. 309. Revocation and suspension of licenses; cease and desist orders.
"Sec. 310. Examinations and investigations.
"Sec. 311. Injunctions and other orders.
"Sec. 312. Conflicts of interest.
"Sec. 313. Removal or suspension of directors and officers of licensees.
"Sec. 314. Unlawful acts and omissions by officers, directors, employees, or agents; breach of fiduciary duty.
"Sec. 315. Penalties and forfeitures.
"Sec. 316. Jurisdiction and service of process.
"Sec. 317. Interest subsidy.
"Sec. 318. Joint ownership of companies, benefits.
"Sec. 319. Preferred stock asset coverage requirement, exemption.
"Sec. 320. Guaranteed obligations not eligible for purchase by Federal Financing Bank.
"Sec. 321. Issuance and guarantee of trust certificates.
"Sec. 322. Transfer and phase-out.

"PART B

"Sec. 351. Purposes.
"Sec. 352. The Corporation for Small Business Investment.
"Sec. 353. Common and preferred stock.
"Sec. 354. Obligations and securities.
"Sec. 355. Legal investments and exempt securities.
"Sec. 356. Loan and investment operations.
"Sec. 357. Qualification of small business investment companies.
"Sec. 358. Operations of small business investment companies.
"Sec. 359. Special small business investment companies.
"Sec. 360. Audits and reports.
"Sec. 361. Transfer of SBA guaranteed securities to the Corporation."

and

(b) by inserting the following heading prior to section 301:

"PART A".

SEC. 5. Title III of the Small Business Investment Act of 1958 is amended by inserting the following new sections at the end thereof:

"PART B

"PURPOSES

"SEC. 351. The Congress hereby declares that the purposes of part B of this Act are—

"(1) to establish a Government-sponsored private corporation which will be financed by private capital and which will serve as a secondary market and warehousing facility for loans and investments in small business investment companies, including loans guaranteed by the Small Business Administration, and will provide liquidity for small business loans and investments;

"(2) to encourage the formation of new small business investment companies and to stimulate and supplement the orderly and necessary flow of private equity capital and long-term loan funds to and improve the distribution of investment capital available for small-business concerns as defined under this Act; and

"(3) to amend the Small Business Investment Act of 1958 to provide for an orderly transfer of certain functions of, and securities guaranteed or owned by, the Small Business Administration to the Corporation

for Small Business Investment as constituted under this Act.

"THE CORPORATION FOR SMALL BUSINESS INVESTMENT

"SEC. 352. (a) There is hereby created a body corporate to be known as the Corporation for Small Business Investment (hereinafter referred to as the 'Corporation'). The Corporation shall have succession until dissolved. It shall maintain its principal office in the District of Columbia and shall be deemed, for purposes of venue and jurisdiction in civil actions, to be a resident and citizen thereof. Offices may be established by the Corporation in such other place or places it may deem necessary or appropriate for the conduct of its business.

"(b) The Corporation, including its franchise, capital, reserves, surplus, mortgages, or other security holdings, and income, shall be exempt from all taxation now or hereafter imposed by any State, or by any county, municipality, or local taxing authority, except that any real property of the Corporation shall be subject to State, county, municipal, or local taxation to the same extent according to its value as other real property is taxed.

"(c) Within sixty days of the date of enactment of this Act, an interim Board of Directors of the Corporation shall be appointed by the President, one of whom the President shall designate as interim Chairman. The interim Board shall consist of five members, two of whom shall be representative

of small business, two of whom shall be representative of small business investment companies, and one of whom shall be the Administrator. The interim Board shall arrange for an initial offering of common stock and take whatever other actions are necessary to proceed with the operations of the Corporation.

"(d) The Corporation shall have a permanent Board of Directors which consist of fifteen persons. When small business investment companies have purchased and fully paid for $15,000,000 of common stock of the Corporation, the holders of such common stock shall elect ten members to the Board of Directors. The President shall appoint the remaining five directors.

"(e) At the time the events described in subsection (d) of this section have occurred, the interim Board shall turn over the affairs of the Corporation to the permanent Board of Directors. The directors appointed by the President shall serve at the pleasure of the President and until their successors have been appointed and have qualified. The Board shall at all times have as members appointed by the President at least one person from a small business investment company operating under section 359 of this Act, and two persons who shall be representative of small business. The directors elected by the common shareholders shall each be elected for a term ending on the date of the next annual meeting of the

common stockholders of the Corporation, and shall serve until their successors have been elected and have qualified. Any appointive seat on the Board which becomes vacant shall be filled by appointment of the President. Any elective seat on the Board which becomes vacant after the annual election of the directors shall be filled by the Board, but only for the unexpired portion of the term.

"(f) The Board shall determine the general policies which shall govern the operations of the Corporation. The Board shall select, appoint, and compensate qualified persons to fill the offices as may be provided for in the bylaws, with such executive functions, powers, and duties as may be prescribed by the bylaws or by the Board of Directors, and such persons shall be the executive officers of the Corporation and shall discharge all such executive functions, powers, and duties.

"(g) The Corporation shall have power—

"(1) to sue and be sued, complain and defend, in its corporate name and through its own counsel;

"(2) to adopt, alter, and use the corporate seal, which shall be judicially noticed;

"(3) to adopt, amend, and repeal by its Board of Directors, bylaws, rules, and regulations as may be necessary for the conduct of its business;

"(4) to conduct its business, carry out its operations, and have officers and exercise the powers granted by this section in any State without regard to any qualification, licensing, or similar statute in any State;

"(5) to lease, purchase, or otherwise acquire, own, hold, improve, use, or otherwise deal in and with any property, real, personal, or mixed, or any interest therein, wherever situated;

"(6) to accept gifts or donations of services, or of property, real, personal, or mixed, tangible or intangible, in aid of any of the purposes of the Corporation;

"(7) to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of its property and assets;

"(8) to appoint such attorneys, officers, employees, and agents as may be required, determine their qualifications, define their duties, fix their compensation, require bonds from them and fix the penalty thereof; and

"(9) to enter into contracts, to execute instruments, to incur liabilities, and to do all things as are necessary or incidental to the proper management of its affairs and proper conduct of its business.

"(h) When the permanent Board of Directors is duly constituted and the Corporation is ready to conduct business, it shall so notify the Administration.

"COMMON AND PREFERRED STOCK

"SEC. 353. (a)(1) The Corporation shall have voting common stock, having such par value as may be fixed by its Board of Directors from time to time, which may be issued only to small business investment companies. Each share of voting common stock shall be vested with all voting rights, each share being entitled to one vote with rights of cumulative voting at all elections of directors. The free transferability of the voting common stock at all times to any person, firm, corporation, or other entity shall not be restricted except for the restriction in subparagraph (5)(B) of this subsection and except that, as to the Corporation, it shall be transferable only on the books of the Corporation. The initial maximum number of shares of voting common stock that the Corporation may issue and have outstanding shall be one hundred million shares. The maximum number of shares of voting common stock may be increased or decreased by the affirmative vote of the holders of at least a majority of the total outstanding shares.

"(2) The Corporation is authorized to issue nonvoting common stock having such par value as may be fixed by its Board of Directors from time to time. The initial maximum number of shares of nonvoting common stock that the Corpo-

ration may issue and have outstanding shall be one hundred million shares. The maximum number of shares of nonvoting common stock may be increased or decreased by the affirmative vote of the holders of at least a majority of the total outstanding shares. Any nonvoting common share issued shall be fully transferable, except that, as to the Corporation, it shall be transferable only on the books of the Corporation.

"(3) The holders of the voting or nonvoting common stock shall not have preemptive rights.

"(4) In order to accumulate funds for its capital surplus account from private sources—

"(A) the Corporation shall require each small business investment company to make payments of nonrefundable capital contributions not to exceed 2 per centum of the private capital of each such company;

"(B) the Corporation also may require each small business investment company to make payments of nonrefundable capital contributions not to exceed 2 per centum of any increases in the private capital of each such company; and

"(C) the Corporation also may require each small business investment company which sells a small business investment security to the Corporation to make, or commit to make, a nonrefundable capital contribu-

tion not to exceed 1 per centum of the unpaid principal balance of such security;

"(5)(A) The Corporation, from time to time, shall issue to each small business investment company its voting common stock evidencing any capital contributions made pursuant to paragraph (4) of this subsection.

"(B) Such voting common stock shall be retained by such companies for a period of not less than three years, subject to such conditions as may be established by the Corporation.

"(C) In addition, the Corporation may issue shares of nonvoting common stock in return for appropriate payments into capital or capital and surplus.

"(D) Such dividends as may be declared by the Board of Directors in its discretion shall be paid by the Corporation to the holders of its voting and nonvoting common stock.

"(6) Notwithstanding any other provision of law, any depository institution, as defined in section 19(b)(1)(A) of the Federal Reserve (12 U.S.C. 461(b)(1)(A)), shall be authorized to make payments to the Corporation of the capital contributions referred to in this subsection, to receive stock of the Corporation evidencing such capital contributions, to purchase additional shares of such stock, and to hold or dispose of such stock, subject to the provisions of this Act.

"(b)(1) The Corporation is authorized to issue nonvoting preferred stock, having such par value as may be fixed by its Board of Directors from time to time. Any preferred share issued shall be freely transferable, except that, as to the Corporation, it shall be transferable only on the books of the Corporation.

"(2) The holders of the preferred shares shall be entitled to such rate of cumulative dividends and such shares shall be subject to such redemption or other conversion provisions as may be provided for at the time of issuance. No dividends shall be payable on any share of common stock at any time when any dividend is due on any share of preferred stock and has not been paid. The Corporation may prescribe that any class of preferred stock of the Corporation may be converted into voting or nonvoting common stock of the Corporation.

"(3) In the event of any liquidation, dissolution, or winding up of the Corporation's business, the holders of the preferred shares shall be paid in full at par value thereof, plus all accrued dividends, before the holders of the common shares receive any payment.

"OBLIGATIONS AND SECURITIES

"SEC. 354. (a) The Corporation is authorized to issue and have outstanding obligations having such maturities and bearing such rate or rates of interest as may be determined by the Corporation. Such obligations shall be issued at such times, bear interest at such rates, and contain such terms and

conditions as the Corporation shall determine, with the approval of the Secretary of the Treasury. Such obligations may be redeemable at the option of the Corporation before maturity in such manner as may be stipulated therein. The Corporation shall insert appropriate language in each of its obligations issued under this section and under section 356 clearly indicating that such obligations, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality thereof other than the Corporation. The Corporation is authorized to purchase in the open market any of its obligations outstanding under this subsection at any time and at any price. Any obligation or security of the Corporation may be issued and sold in definitive form, in book entry form or in such other form, with or without delivery of physical evidence of ownership, as shall be prescribed by the Corporation.

"(b) For the purposes of this section, the Corporation is authorized to issue obligations which are subordinated to any or all other obligations of the Corporation, including subsequent obligations. The obligations issued under this section shall have such maturities and bear such rate or rates of interest as may be determined by the Corporation and may be made redeemable at the option of the Corporation before maturity in such manner as may be stipulated in such obliga-

tions. Any of such obligations may be made convertible into shares of common stock in such manner, at such price or prices, and such time or times as may be stipulated therein.

"(c) The Secretary of the Treasury, in his discretion, may purchase any obligations issued by the Corporation pursuant to subection (a) of this section as now or hereafter in force and for such purpose the Secretary of the Treasury is authorized to use as a public debt transaction the proceeds of the sale of any securities hereafter issued under the Second Liberty Bond Act (40 Stat. 288), as amended as now or hereafter in force, and the purposes for which securities may be issued under such Act, as now or hereafter in force, are extended to include such purchases. The authorities provided to the Secretary of the Treasury by the preceding sentence shall be effective only to such extent and in such amounts as are provided in advance in appropriations Acts. The Secretary of the Treasury shall not at any time purchase any obligations under this subsection if such purchase would increase the aggregate principal amount of his then outstanding holdings of such obligations under this subsection to an amount greater than $500,000,000. Each purchase of obligations by the Secretary of the Treasury under this subsection shall be on terms and conditions as shall be determined by the Secretary of the Treasury, taking into consideration the objectives that the Corporation retain the ability to make credit available to eli-

gible borrowers on reasonable terms as reflected in the current average rate on outstanding marketable obligations to the United States of comparable maturities as of the last day of the month preceding the making of such purchase. The Secretary of the Treasury may, at any time, sell, on such terms and conditions and at such price or prices as the Secretary may determine, any of the obligations acquired by the Secretary under this section. All redemptions, purchases, and sales by the Secretary of the Treasury of such obligations under this section shall be treated as public debt transactions of the United States.

"LEGAL INVESTMENTS AND EXEMPT SECURITIES

"SEC. 355. All obligations issued by the Corporation pursuant to sections 354 and 356, all preferred stock issued by the Corporation pursuant to section 353(b) and all obligations guaranteed by the Corporation pursuant to section 356 shall be lawful investments, and may be accepted as security for all fiduciary, trust, and public funds, the investment or deposit of which shall be under authority or control of the United States or of any officer or officers thereof. All stock and obligations issued by the Corporation shall be deemed to be exempt securities within the meaning of laws administered by the Securities and Exchange Commission, to the same extent as securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States. The Corporation shall, for the purposes of section

14(b)(2) of the Federal Reserve Act (12 U.S.C. 355(2)), be deemed to be an agency of the United States. The obligations of the Corporation shall be deemed to be obligations of the United States for purposes of section 3124 of title 31, United States Code. For the purpose of section 101(39) of title 11, United States Code, the Corporation shall be deemed to be an agency of the United States; however, for the purpose of section 101(33) of title 11, United States Code, the Corporation shall not be deemed to be a governmental unit, but instead shall be deemed to be a corporation.

"LOAN AND INVESTMENT OPERATIONS

"SEC. 356. (a) After the permanent Board of Directors has been duly constituted and the debentures purchased as provided in section 361 of this Act, the Corporation is authorized, subject to the provisions of this section, pursuant to commitments or otherwise, to make advances on the security of, purchase, or repurchase, service, sell or resell, offer participations or pooled interests or otherwise deal in, at prices and on terms and conditions determined by the Corporation, small business investment securities.

"(b) Notwithstanding the provisions of any State law to the contrary, including the Uniform Commercial Code as in effect in any State, a security or ownership interest in small business investment securities created by the Corporation or by any eligible small business investment company may be perfected either through the taking of possession of such se-

curities or by the filing of notice of such interest in such securities in the manner provided by such State law for perfection of security or ownership interests in accounts.

"(c) The Corporation is authorized to guarantee securities based on or secured by pools or trusts of the small business investment securities eligible for purchase by the Corporation under this section and to act either as issuer or as guarantor of such securities issued by an eligible small business investment company. Such securities shall bear interest at a rate equal to the rate on the underlying small business investment securities less an allowance for servicing and other expenses as determined by the Corporation.

"(d) Securities issued pursuant to subsection (c) of this section may be in the form of debt obligations secured by pools of loans, or trust certificates of beneficial ownership in such pools of loans or both. Small business investment securities set aside pursuant to the offering of participations or pooled interests shall at all times provide for payments that, in the reasonable judgment of the Corporation, are adequate to ensure the timely principal and interest payments on such securities.

"(e) Nothing contained in this section shall be construed to impede small business investment companies operating under section 359 of this Act from receiving a proportionate and fair share of available funds.

"QUALIFICATION OF SMALL BUSINESS INVESTMENT COMPANIES

"SEC. 357. (a) The Corporation shall establish appropriate criteria for the qualification of small business investment companies to conduct business with the Corporation. Such criteria may include, among other things, the general business reputation and character of the owners and management of the small business investment company, and the probability of successful operations of such small business investment company, including adequate profitability and financial soundness. Licensees in good standing which make capital contributions and acquire and maintain common stock of the Corporation pursuant to section 353(a) of this Act, contract with the Corporation pursuant to the provisions of section 358(a) of this Act, and authorize the release of records to the Corporation pursuant to section 322(d) of this Act shall be deemed to be qualified under this section.

"(b) Each small business investment company authorized to operate under the authority of Part B this Act shall have private capital of not less than $1,000,000. In all cases, such private capital shall be in an amount adequate to assure a reasonable prospect that the company will be operated soundly and profitably, and managed actively and prudently.

"(c) Notwithstanding the provisions of section 23A of the Federal Reserve Act (12 U.S.C. 371c), ownership inter-

ests in small business investment companies shall be eligible for purchase by national banks, and shall be eligible for purchase by other member banks of the Federal Reserve System and nonmember insured banks to the extent permitted under applicable State law; except that in no event may any such bank acquire ownership interests in any small business investment company if, upon the making of that acquisition the aggregate amount of ownership interest in small business investment companies then held by the bank would exceed five percentum of its capital and surplus.

"(d) Each small business investment company shall have authority to purchase stock issued by the Corporation and to borrow money and to issue its debenture bonds, promissory notes, or other obligations under such general conditions and subject to such rules as the Corporation may prescribe.

"(e) Thirty days after the Administration receives notice from the Corporation pursuant to section 352(h) of this Act, the provisions of sections 301–306 inclusive, sections 308–318 inclusive, and sections 320 and 321, of this Act shall be inapplicable to small business investment companies which qualify under section 357(a) or section 359(a) of this Act and which remain qualified to conduct business with the Corporation.

"(f) All specific references to small business investment companies operating under the Small Business Investment

Act of 1958 in any law of the United States, or regulations promulgated thereunder by any agency of the United States Government, or any law of any State in effect on the effective date of this Act, shall be deemed to refer to and include small business investment companies operating under the provisions of part B of this Act.

"OPERATIONS OF SMALL BUSINESS INVESTMENT COMPANIES

"SEC. 358. (a) The Corporation shall enter into agreements with small business investment companies qualified under section 357 or section 359 of this Act governing the operations of such companies, in accordance with the provisions and purposes of this Act.

"(b) Each small business investment company is authorized to provide equity capital and loans to small-business concerns, in such manner and under such terms as the small business investment company may fix in accordance with the rules of the Corporation. Equity investments and loans made under this section may be made directly or in cooperation with other investors or lenders on a participation or guaranteed basis. Each small business investment company may provide consulting and advisory services on a fee basis and have on its staff persons competent to provide such services.

"(c) Small business investment companies shall engage only in the activities contemplated by this Act and in no other activities.

"(d) For the purpose of eliminating conflicts of interest which may be detrimental to small-business concerns, to small business investment companies, to the shareholders or partners of either, to the Corporation, or to the purposes of this Act, the Corporation shall adopt rules to govern transactions with any officer, director, shareholder, or partner of any small business investment company, or with any person or concern, in which any interest, direct or indirect, financial or otherwise, is held by any officer, director, shareholder, or partner of (A) any small business investment company, or (B) any person or concern with an interest, direct or indirect, financial or otherwise, in any small business investment company.

"(e) The Corporation shall adopt rules which shall provide that small business investment companies, either singularly or jointly, shall not be permitted to assume control over small-business concerns except on a temporary basis if reasonably necessary for the protection of its investment and then only under restrictions as determined by the Corporation.

"(f) Except as otherwise provided by the rules of the Corporation, financings of small-buisness concerns by small business investment companies shall be for a minimum period of five years. In the case of small business investment companies operating under section 359 of this Act, financings shall

be for the minimum period of four years, except as otherwise provided by the rules of the Corporation.

"(g) Without the approval of the Corporation, the aggregate amount of obligations and securities acquired and for which commitments may be issued by any small business investment company under the provisions of this Act for any single enterprise shall not exceed 20 per centum of the private capital of such company. In the case of small business investment companies operating under section 359 of this Act, the limitation shall be 30 per centum.

"(h) Small business investment companies shall not provide financing to a small-business concern for relending, foreign investments, passive investments or the acquisition of farm land. For purposes of this subsection, farm land shall mean land which is or is intended to be used for agricultural or forestry purposes, such as the production of food, fiber, or wood, or is so taxed or zoned.

"(i) Each small business investment company shall be subject to an annual audit and shall make such reports to the Corporation at such times and in such form as the Corporation may require.

"(j) The Corporation shall adopt appropriate measures to assure compliance by small business investment companies with the provisions of this section. Failure by a small business investment company to comply with the provisions of

this section shall entitle the Corporation to terminate or suspend the agreements between the Corporation and a small business investment company or to take corrective action warranted under the circumstances which shall include, but is not limited to: suspensison or termination of agreements between the Corporation and such company; assessment of penalties against such company or its officers or directors: or removal or suspension of officers or directors of such company. In appropriate cases, the Corporation is authorized, in its discretion, to refer violations of the provisions of this section to the Administration for investigation or to refer such violations to the United States attorney in the jurisdiction in which such violations may have occurred or in which the small business investment company, or its officers or directors, are located.

"(k) In order to facilitate the orderly and necessary flow of long-term loans and equity funds from small business investment companies to small-business concerns, the provisions of the Constitution or the laws of any State expressly limiting the rate or amount of interest, discount points, finance charges or other charges which may be charged, taken, received, or reserved by lenders shall not apply to any business loan made by a small business investment company pursuant to provisions of this Act. This subsection shall apply to business loans made by a small business investment com-

pany in any State on or after the effective date of this Act, unless such State adopts a law or certifies that the voters of such State have voted in favor of any provision, constitutional or otherwise, which states explicitly and by its terms that such State does not want the provisions of the subsection to apply to business loans made in such State. In any case in which a State takes an action described in this subsection, such State or constitutional or other provision shall not apply after the date such action was taken with respect to any business loan made by a small business investment company pursuant to a commitment to make such loan which was entered into on or after the effective date of this Act and prior to the date on which such action was taken.

"SPECIAL SMALL BUSINESS INVESTMENT COMPANIES

"SEC. 359. (a) The Corporation shall adopt reasonable criteria regarding the qualification of a special type of small business investment company (hereinafter referred to as 'special small business investment companies'), the investment policy of which is that its investments will be made solely in disadvantaged small-business concerns. Licensees in good standing operating under the provisions of section 301(d) of this Act which make capital contributions and acquire and maintain common stock of the Corporation pursuant to section 353(a) of this Act, contract with the Corporation pursuant to the provisions of section 358(a) of this Act, and authorize the release of records to the Corporation pursuant to

section 322(d) of this Act shall be deemed to be qualified under this section.

"(b) In order to benefit special small business investment companies, there is hereby authorized and created a special-purpose trust (hereinafter referred to as the 'Trust') which shall operate in conjunction with the Corporation as follows:

"(1) The Trust shall operate in accordance with a trust agreement between the Trust and the Corporation to carry out the purposes of this Act.

"(2) The Trust shall be administered by five trustees, three of whom shall be nominated by the special small business investment companies and appointed by the Board of Directors of the Corporation. At least three of the trustee shall, at all times, be persons from special small business investment companies. One of the trustees shall be appointed by the President, to serve at the pleasure of the President, and one of the trustees shall be ex-officio, the Chairman of the Board of Directors of the Corporation, or his designee.

"(3) The nomination of trustees by special small business investment companies shall be by vote of such companies, which shall be cumulative, by number of shares of voting common stock of the Corporation held by each such company. Each of the trustees nominated

by the special small business investment companies shall be appointed as trustees by the Board of Directors of the Corporation unless such Board, for good cause shown, refuses to approve any such nominee, in which event a new nominee shall be nominated by the special small business investment companies. Nominees, upon appointment by the Board, shall serve for terms of three years, and no such trustee shall serve more than two consecutive terms.

"(4) The trustees appointed by the Corporation shall have custody and control of the trust estate to administer, sell, invest and reinvest the trust estate with the care, skill, purdence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

"(5) The Trust shall establish separate accounting for all preferred securities, debentures, loss reserves and other funds acquired and the application of funds for the purposes specified in this section. The trustees shall make an annual accounting of the Trust's operations to the Secretary of the Treasury.

"(c) Within thirty days after the Administration receives notice from the Corporation pursuant to section 352(h) of this

Act, the Administration shall convey to the Corporation in trust all of the right, title, and interest to all preferred securities and debentures issued by small business investment companies operating under authority of section 301(d) of this Act, and held by the Administration. The Corporation shall grant and convey to the Trust such securities and debentures and other funds designated for the Trust in trust, to be administered in accordance with the provisions of this Act.

"(d) The Trust shall apply all of the funds held in trust and income thereon, dividends on any preferred securities held in trust, and interest on any debentures held in trust, together with the proceeds from any retired preferred securities held in trust, and proceeds from any maturing debentures held in trust—

"(1) to cover any losses realized on preferred securities or debentures held in trust, preferred securities purchased by the Trust in accordance with the provisions of this section or debentures purchased or guaranteed by the Corporation in accordance with the provisions of this section;

"(2) to reduce the interest rate on debentures purchased or guaranteed by the Corporation in accordance with the provisions of subsection (e) of this section;

"(3) to purchase preferred securities in accordance with the provisions of subsection (e) of this section; and

"(4) to cover the operating costs of administering the Trust.

"(e) The trustees of the Trust are authorized to purchase preferred securities, and the Corporation is authorized to purchase, or to guarantee the timely payment of all principal and interest payments as scheduled, on debentures issued by special small business investment companies. Such purchases or guarantees may be on such terms and conditions as the Trust or the Corporation deems appropriate, subject to the following:

"(1) The Trust may purchase shares of nonvoting stock (or other securities having similar characteristics) issued by special small business investment companies, provided—

"(A) dividends are preferred and such securities are subject to such rate of cumulative dividends, redemption or other conversion provisions, terms and conditions as may be determined by the Trust;

"(B) on liquidation or redemption, the Trust is entitled to the preferred payment of the par value of such securities; and prior to any distribution (other than to the Trust) the Trust shall be paid any amounts as may be due pursuant to subparagraph (A) of this paragraph;

"(C) the purchase price shall be at a price determined by the Trust and, in any one sale, $50,000 or more; and

"(D) the amount of such securities purchased and outstanding at any one time shall not exceed 200 per centum of the private capital of such company. The amount of such securities purchased by the Trust in excess of 100 per centum of such private capital from any company may not exceed an amount equal to the amount of its funds invested in or legally committed to be invested in venture capital as determined by the Trust. For the purpose of the subsection, the term 'venture capital' means stock of any class (including preferred stock) or limited partnership interests, or shares in a syndicate, business trust, joint stock company or association, mutual corporation, cooperative or other ventures for profit or debt instruments which are subordinate by their terms to other borrowings of the issuer.

"(2) The Corporation may purchase or guarantee debentures issued by special small business investment companies which shall be subordinate to any other debentures, bonds, promissory notes or other debts and obligations of such companies unless the Corporation in

its exercise of reasonable investment prudence and in considering the financial soundness of such company determines otherwise, provided—

"(A) the effective rate of interest during the first five years of the term of any debenture purchased by the Corporation under authority of this section shall be at a rate determined by the Corporation to be the rate of return on comparable small business investment securities purchased by the Corporation reduced to such lower rate as determined and provided by the Trust, such reduction in rate not to exceed 3 per centum per annum; and

"(B) the amount of debentures purchased or guaranteed and outstanding at any one time pursuant to this subsection or transferred to the Trust under subsection (c) of this section shall not exceed 400 per centum of a company's private capital less the amount of preferred securities outstanding.

"(3) Debentures purchased and outstanding pursuant to paragraph (2) of this subsection (e) may be retired simultaneously with the issuance of preferred securities to meet the requirements of subparagraph (2)(B) of this subsection (e).

"(f) The Trust and the Corporation are authorized to extend the benefits of this section to any special small business investment company which is owned, in whole or in part, by one or more small business investment companies, in accordance with rules promulgated by the Trust and the Corporation.

"(g) All dividends on preferred securities, interest on debentures, gains from sales of any securities and all other income of the Trust shall be exempted from all taxation now or hereafter imposed by the Congress or by any State or by any country, municipality, or local taxing authority.

"(h) Fifty years after the effective date of this Act, all preferred securities purchased by the Trust from special small business investment companies shall be redeemed and, together with the remaining corpus and interest of the Trust, less any funds owed to the Corporation, shall be transferred by the Trust to the United States Treasury for covering into miscellaneous receipts. Thereafter, the Trust shall be terminated and special small business investment companies operating under the authority of this section shall operate under the authority of section 357 of this Act.

"AUDITS AND REPORTS

"SEC. 360. (a) The Administration shall have review authority over the Corporation to ensure that the public purposes of this Act are carried out. The Administration's reviews shall cover the Corporation's criteria for the qualifica-

tion of small business investment companies to conduct business with the Corporation and the Corporation's agreements, rules or regulations governing the operations of small business investment companies, but shall not extend to the Corporation's internal operations such as personnel, salary, and other usual corporate matters.

"(b) The Administration may examine the books and records of the Corporation and may require the Corporation to make such reports as the Administration deems desirable. The Administration, not later than January 31 of each year, shall report to the Congress on reviews made under this section.

"(c) The accounts of the Corporation shall be audited annually. Such audits shall be conducted in accordance with generally accepted auditing standards by independent certified public accountants who are certified or licensed by a regulatory authority of a State or other political subdivision of the United States. A report of each such audit shall be furnished to the Secretary of the Treasury. The audit shall be conducted at the place or places where the accounts are normally kept. The representatives of the Secretary shall have access to all books, accounts, financial records, reports, files, and all other papers, things, or property belonging to or in use by the Corporation and necessary to facilitate the audit, and they shall be afforded full facilities for verifying transac-

tions with the balances or securities held by depositaries, fiscal agents, and custodians.

"(d) A report of each such audit for a fiscal year shall be made by the Secretary of the Treasury to the President and to the Small Business Committees of the Congress not later than six months following the close of such fiscal year. The report shall set forth the scope of the audit and shall include a statement (showing intercorporate relations) of assets and liabilities, capital and surplus or deficit; a statement of surplus or deficit analysis; a statement of income and expense; a statement of sources and application of funds; and such comments and information as may be deemed necessary to keep the President and the Congress informed of the operations and financial condition of the Corporation, together with such recommendations with respect thereto as the Secretary may deem advisable, including a report of any impairment of capital or lack of sufficient capital noted in the audit. A copy of each report shall be furnished to the Administration and to the Corporation. In addition to such annual audits, the Corporation shall be subject to audit by the General Accounting Office, at the request of either of the Small Business Committees of the Congress, as long as the Corporation holds small business investment company securities guaranteed by the Administration and acquired by the Corporation pursuant to section 361 of this Act.

"(e) The Corporation shall, as soon as practicable after the end of each fiscal year, transmit to the President, the Small Business Committees of the Congress and the Administration a report of its operations and activities during last year.

"TRANSFER OF SMALL BUSINESS ADMINISTRATION GURANTEED SECURITIES TO THE CORPORATION

"SEC. 361. (a) To carry out the purposes set forth in section 351 of this Act, and notwithstanding any law, rule, or regulation, the Secretary of the Treasury is authorized and directed to sell to the Corporation during fiscal year 1987, all of the right, title and interest to all small business investment company securities guaranteed by the Administration and held by the Federal Financing Bank (the 'Bank'), providing such securities are due in fiscal year 1988 or any subsequent year. The Corporation shall fully pay in cash for such securities during fiscal year 1987 at a price equal to the outstanding principal balance of such securities, except that $100,000,000 of the purchase price shall be paid by the Corporation to the trustees for the Trust to carry out the trust functions specified in section 359 of this Act. Such securities may be freely transferred, hypothecated or sold by the Corporation. Interest on such securities shall accrue to the benefit of the Bank up to the date of transfer of title of the securities from the Bank to the Corporation.

"(b) To the extent the Corporation is prepared to conduct business during fiscal year 1987, the Secretary of the Treasury is authorized to sell to the Corporation during fiscal year 1987, all of the right, title and interest to any small business investment company securities guaranteed by the Administration and held by the Bank which are due in fiscal year 1987. The Corporation shall fully pay in cash for such securities during fiscal year 1987 at a price equal to the outstanding principal balance of such securities. Such securities may be freely transferred, hypothecated or sold by the Corporation. Interest on such securities shall accrue to the benefit of the Bank up to the date of transfer of title of the securities from the Bank to the Corporation.".

SEC. 6. Except as otherwise provided in this Act, or as otherwise provided by the Corporation or by laws hereafter enacted by the Congress expressly in limitation of provisions of this Act, the powers and functions of the Corporation and of the Board of Directors shall be exercisable, and the provisions of this Act shall be applicable and effective, without regard to any other law.

SEC. 7. Notwithstanding any other law this Act shall be applicable to the several States, the District of Columbia, the Commonwealth of Puerto Rico, and the territories and possessions of the United States.

Mr. MITCHELL. I will ask if Mr. Slaughter has an opening statement this morning.

Mr. SLAUGHTER. No, Mr. Chairman.

Mr. MITCHELL. Thank you.

Mr. SLAUGHTER. Thank you.

Mr. MITCHELL. I think during the course of the testimony we will be able to cover many of the major points that I would want to have covered in my opening statement.

Our leadoff witness is Mr. Robert Turnbull, Associate Deputy Administrator for Management and Administration with the Small Business Administration. And you have several other people with you from the Office of Finance and Investment. Thank you, gentlemen, for being here.

If you will proceed with your statement we will be most grateful to you.

**TESTIMONY OF ROBERT A. TURNBULL, ASSOCIATE DEPUTY ADMINISTRATOR FOR MANAGEMENT AND ADMINISTRATION, SMALL BUSINESS ADMINISTRATION, ACCOMPANIED BY EDWIN T. HOLLOWAY, ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT; AND ROBERT G. LINEBERRY, DEPUTY ASSOCIATE ADMINISTRATOR**

Mr. TURNBULL. Thank you, Mr. Chairman.

Mr. MITCHELL. Since we have had the opportunity of reading your statement, if you will capsulize it I would be very grateful.

Mr. TURNBULL. Be glad to. Thank you.

As you mentioned, with me here today, Mr. Chairman, are Mr. Ed Holloway who is the Associate Administrator of Finance and Investment, on my right, and Bob Lineberry who is the Deputy Associate Administrator for Investment.

In summary, Mr. Chairman, SBA supports wholeheartedly the concept of privatizing the SBIC Program and other financial programs within SBA. Unfortunately, we cannot support this legislation, H.R. 5019, because we believe that it would result in considerable cost to the taxpayer and may be unfair to many present SBIC license holders.

Regarding the cost issue, our reading of the legislation shows that this bill would cost approximately $505 million in up-front capital, consisting of a $150 million windfall from the sale of SBIC paper, $255 million in a transfer of MESBIC assets from SBA to COSBI, and a $100 million grant to COSBI MESBIC Trust from the purchase of SBIC paper from the FFB.

Beyond the initial capitalization, the Secretary of the Treasury could be called upon to grant an additional $500 million in capital injection. And the SBA guarantee is conveyed in the sale of the SBIC paper for a continuing $1 billion cost contingent liability.

While our liability, Mr. Chairman, is not diminished in this case, our ability to protect our portfolio interest is. There are presently 185 SBIC license holders who do not use SBA leverage who would have to give up their licenses under this provision or comply with COSBI requirements. We do not believe that this is a fair requirement or one that would be positive for the small business community at large.

Mr. Chairman, I have operational problems that we envision.[1]

In closing Mr. Chairman, we believe that, for our previously-stated objections, which have not been overcome with this bill, we must oppose this piece of legislation.

We will be happy to answer any of your questions.

[Mr. Turnbull's prepared statement, with attachments, follows:]

PREPARED STATEMENT OF ROBERT A. TURNBULL, ASSOCIATE DEPUTY ADMINISTRATOR, MANAGEMENT AND ADMINISTRATION, SBA

Mr. Chairman, thank you for inviting SBA to appear and testify on H.R. 5019, which, if passed by the Congress and approved by the President, would create the Corporation for Small Business Investment [COSBI].

This bill intends to create COSBI to provide a new method of financing and regulating the Small Business Investment Company [SBIC] Program.

This bill is the third version in two years of COSBI legislative proposals. The first was introduced in the Senate as S. 2686 on May 17, 1984, and the second was introduced in the House of Representatives as H.R. 3484 on October 2, 1985. SBA was asked by Senator Weicker to comment on the two previous versions and did so on December 11, 1984, and January 21, 1986, respectively. SBA supplied a copy of its January 21, 1986, comments to this committee.

At this time, if there is no objection, I would like to submit copies of those two SBA letters for the record.

While SBA fully supports the concept and principle of truly privatizing the SBIC Program, we must oppose this bill because it does not address or cure the major objections which led to our opposition of the two previous versions. In fact, it continues, with enhancements, key elements of Federal financial support while greatly weakening Government financial and regulatory oversight. The bill, in our opinion, does not meet the objective of replacing Federal financial assistance of SBIC's with private financial support. This testimony will be limited to comments on the major policy issues and does not represent a section by section discussion.

The proposed new section 354(c) authorizes the Secretary of the Treasury, if provided for in advance by an appropriations act, to purchase up to $500 million of COSBI obligations for the purpose of supporting the continuing funding of SBIC's. It is our view that this open-ended backstop line of credit is not consistent with the principles of privatization and is unacceptable.

The bill would provide, in section 361, for sale of approximately $1 billion of SBA-guaranteed SBIC debentures by the U.S. Treasury to COSBI at their outstanding balances [PAR]. The SBA guarantee would continue on these debentures risking significant Federal outlays for years to come without providing for adequate financial consideration for this risk. These debentures, at the present time, have market value in excess of par and, based upon present interest rates, such a sale at par rather than market value would provide a substantial windfall to COSBI at the expense of the U.S. Treasury. That windfall today is estimated to be as high as $150 million. In the absence of that windfall, the necessity of such a cash sale to the formation of COSBI must be questioned.

In addition to the borrowing power from the Treasury, the windfall from the purchase of debentures from the Treasury at less than their market value, and the continuing of the full faith and credit guarantee of SBA on the debentures, the bill provides, in section 361, for a $100 million cash grant to a special-purpose trust to be operated by COSBI for the benefit of section 301(d) licensees [MESBIC's]. Also, in section 359, the bill provides for the grant and conveyance to the special-purpose COSBI trust, for no consideration, of $255 million of agency assets. These assets are the outstanding preferred stock and debentures of MESBIC's accumulated in the MESBIC Program up to this time. The trust beneficiaries would be MESBIC Program participants and a majority of the trustees would be MESBIC representatives.

The combination of the windfall to COSBI from its purchase of SBA guaranteed debentures, the cash grant, and the conveyance of SBA assets, would represent Federal seed capital for COSBI of approximately $500 million. This, of course, would be in addition to the Government's continuing timely payment guarantee on assets purchased by COSBI, and the contingent Treasury authority to purchase COSBI obligations.

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[1] Microphone failed and certain materials were lost.

The bill, in section 353, requires each Small Business Investment Company Qualifying for COSBI to purchase, in an amount up to 2 percent of its private capital, the common stock of COSBI. This would represent an initital investment by the SBIC industry of only about $25 million, if all SBIC's and MESBIC's chose to qualify.

The Federal Government's continuing financial risk, in the form of guarantees on the purchased debentures and the future borrowings from the Treasury, coupled with the seed capital in the form of grants and purchase price concessions on the SBIC debentures, would be substantially greater than the licensees' $25 million and it is for that reason that this bill in our opinion would not accomplish its intended objectives.

The effect of these provisions of the bill is mainly to supplement existing Federal support of these programs with up-front concessions and grants, and future borrowing power from the U.S. Treasury, in case these concessions and grants prove insufficient or should COSBI experience operating difficulties.

In light of this substantial Federal financial support, the bill does not, in our opinion, provide for the proper breadth and depth of direct Federal management, control, or oversight. It does not provide for direct regulatory authority over SBIC's and MESBIC's by SBA's inspector general, enforcement powers to SBA, nor the direct executive branch regulatory authority and enforcement powers over the operations of COSBI. We believe that such an imbalance between the Government's financial risk and regulatory authority is not in the Government's best interests and provides little incentive for sound private sector administration of COSBI.

There also is a basic issue of fairness to those SBIC's that have never used SBA funds which should be considered. There are about 185 of these SBIC's with $425 million of private capital. Section 322 would require revocation of these SBIC's licenses within two years of the date that COSBI was operational unless these SBIC's qualify for COSBI by paying 2 percent of their private capital to COSBI for the privilege of continuing to do what many of them have been doing for more than twenty years. This requirement is particularly objectionable as it is unfair to those SBIC's that have served the objectives of the program well without direct or guaranteed Federal financial assistance.

In summary, it is our belief that this bill does not privatize these programs in a financial sense and, thus, its elements that privatize the regulation of SBIC's are inappropriate. Accordingly, we cannot support it.

Thank you for giving us this opportunity to testify on this bill.

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*January 21, 1986.*

Hon. LOWELL WEICKER, JR.,
*Chairman, Committee on Small Business, U.S. Senate, Washington, DC.*

DEAR MR. CHAIRMAN: This replies to your letter of December 16, 1985, requesting the views of the Small Business Administration on a bill, H.R. 3484 which proposes to create a capital bank for small business investment companies.

H.R. 3484 dated October 2, 1985, which would create a Corporation for Small Business Investment (COSBI), is similar in its stated objectives and for the most part its provisions to the bill, S. 2686 dated May 17, 1984, which you introduced for yourself and Senator D'Amato.

As I indicated to you in my letter of December 11, 1984, commenting on S. 2686, we are in agreement with the principle of privatizing the small business investment company program. It would appear, however, that H.R. 3484 does not meet that objective. In some respects it increases the Federal Government's financial support of the program. For example, H.R. 3484, as well as the explanatory material distributed by its proponents shows that:

(1) pursuant to Section 15(a) there would be a $1.0 billion direct obligation of COSBI to the United States Treasury (with no specific due date or amortization provisions for purchase of the SBA-Guaranteed SBIC Debentures (Debentures) presently held by the Federal Financing Bank (FFB): and,

(2) the direct obligation as in (1) above would be at an interest rate 2% per annum below the average weighted interest rate on the Debentures providing an implicit subsidy initially of some $20.0 million annually; and,

(3) pursuant to Section 11(c) the United States Treasury would provide contingent financial support indefinitely of $1.0 billion to COSBI as a backup; and,

(4) pursuant to Section 15(a) the Debentures purchased by COSBI from the FFB rather than securing the $1.0 billion of outstanding obligations to the United States Treasury as in (1) above, would be used to secure the borrowings of COSBI the proceeds of which would not be used to reduce the obligations to the Treasury; and,

(5) Section 301(d) SBICs (MESBICs) would continue to receive government support and a subsidy from a funded trust created pursuant to Section 8 which would receive a capital contribution from the Federal Government of some $350.0 to $400.0 million.

It is noted also that COSBI would have the status of an instrumentality of the United States and be exempted from some of the provisions of the tax and securities laws, see for example Section 12: Further, we are concerned for those SBICs that do not use SBA leverage and might be forced to join and financially support COSBI for no commensurate benefit other than escaping disenfranchisement.

Although this is not an exhaustive analysis of H.R. 3484, it is clear that COSBI would not be privatized in a financial sense and therefore we cannot support the bill.

Ironically, among Federal programs the SBIC Program today seems an ideal candidate for transitioning to fully private funding as envisioned by its authorizing legislation. As we have noted on other occasions, the program has developed a significant human resource in the form of its present complement of seasoned venture capital managers. The collective financial track record of the SBIC industry appears to be superb. For example, during the past five years, it has attained its highest levels of private capitalization, financings to small business concerns, and return on investment both realized and unrealized. We would hope, therefore, to have the opportunity to support legislation which resolves the shortcomings of the present bill and leads to the complete and expeditious disengagement of Federal financial assistance to SBICS.

In our letter to you dated December 11, 1984, which included our comments on your S. 2686, we put forth some guiding principles for the further development of the COSBI concept. Now as then, we stand ready to discuss with you alternate provisions, or other proposals that might accomplish the objective of truly privatizing the SBIC program.

Thank you for the opportunity to provide these comments. We look forward to working with you further on this important matter.

The Office of Management and Budget advises that it has no objection to the submission of this report to the Congress.

Yours truly,

JAMES C. SANDERS,
*Administrator.*

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U.S. SMALL BUSINESS ADMINISTRATION,
*Washington, DC, December 11, 1984.*

Hon. LOWELL WEICKER, Jr.,
*Chairman, Committee on Small Business, U.S. Senate, Washington, DC.*

DEAR MR. CHAIRMAN: This is in response to your request for the views of the Small Business Administration on S. 2686, a bill "To amend the Small Business Investment Act of 1958 to create the Corporation for Small Business Investment and to transfer certain functions of the Small Business Administration to the Corporation."

SBA, although in favor of the concept of privatization of the Small Business Investment Company (SBIC) Program, would oppose the enactment of this bill.

When you introduced this legislation on May 17, 1984, you stated in part: ". . . the legislation is complex and it raises a number of policy and technical issues which should be open to public discussion and comment. Consequently, while I fully support the objective of improving the flow of venture capital to small business, I have introduced the legislation in an effort to initiate public dialog on the proposal, and it does not carry my endorsement at this time."

Our comments on the bill, therefore, are made with your statement in mind and are meant to set forth some basic principles which we feel should guide any further discussions.

PURPOSE OF THE LEGISLATION

The purpose of the bill is to withdraw Federal Government financial support from the SBIC industry, and to replace it with a centralized purely private sector source of funds. Additionally and contemporaneously, the bill proposes to simplify and streamline the regulation of SBICs.

A government-sponsored corporation, the Corporation for Small Business Investment (COSBI), would be created and financed in the private sector that would finance and regulate SBICs. In short, an SBIC for SBICs. There would no longer be a

need for SBA direct or guaranteed authorization and appropriations for those SBICs choosing to qualify and purchase stock in COSBI. MESBICs would be administered by COSBI on behalf of the Federal Government but would still require annual appropriations.

The SBA agrees that the SBIC Industry should make a transition to the private sector as originally intended by Congress. Congress' intent is made clear in the Statement of Policy, Section 102 of the Small Business Investment Act of 1958, as amended, (Act) when it states that: ". . . this policy shall be carried out in such a manner as to insure the maximum participation of private financing sources."

Further, Section 308(g)(2)(A) of the Act specifically requires in SBA's Annual Report: "The Administration's recommendations with respect to the feasibility and organization of a small business capital bank to encourage private financing of small business investment companies to *replace* Government financing of such companies." (Underline added for emphasis.)

However, this bill does not lead to privatization of SBICs; it sets up another Government supported organization. Further, under the present program structure a discernible privatization has occurred. From 1981-1984 there has been an unprecedented increase in private sector funds flowing into small business concerns through both SBICs and non-SBIC sources.

### REGULATION OF SBICS

As long as any SBIC or MESBIC has outstanding any obligation to SBA, any obligation guaranteed by SBA, any preferred stock held by SBA, or enjoys any tax advantage as an SBIC, it should be subject to regulation by SBA.

### REGULATION OF COSBI

During the time that COSBI has any financial obligation outstanding to the Treasury, or enjoys the contingent support of the Treasury, its operations should be regulated by the Federal Government directly, and it should be subject to periodic audits by the General Accounting Office.

### CONTROL OF COSBI

It is contemplated that COSBI would be owned and controlled by SBICs once the initial $20.0 million of voting common stock is issued to SBICs and paid for. It is our opinion that voting control of COSBI should be in the Federal Government, and all the elected Directors of COSBI be elected by the Federal Government (SBA/Treasury) as long as COSBI has any obligations outstanding to Treasury, or enjoys the contingent support of the Treasury.

### ASSIGNMENT OF ASSETS—ASSUMPTION OF DEBTS

The bill provides that COSBI be assigned all SBA-guaranteed SBIC debentures now held by the FFB in consideration of its assumption of all the FFB's obligations to the Treasury related to those debentures. Section 15 of the bill which relates to this transaction should contain specific terms and conditions to that assignment and assumption to avoid any unintended misinterpretation of Congressional intent when the transaction is negotiated. Such terms and conditions should include, but not be limited to, provisions:

(1) that the obligations to Treasury of COSBI be senior to all other borrowings of COSBI; and

(2) that the obligations outstanding to Treasury be fully secured by the pledge of SBA-guaranteed SBIC debentures to which they relate; and

(3) that the voting stock of COSBI be pledged to secure the obligations of COSBI to the Treasury; and

(4) that no dividends, distributions, redemptions, or dispositions of assets may be made by COSBI without prior approval of the Federal Government (SBA/Treasury); and

(5) that the transaction be at par or face value on both sides with no implicit subsidy.

### APPROVAL OF THE SECRETARY OF THE TREASURY

Section II of the bill provides that obligations issued by COSBI shall be issued after *consultation* with the Secretary of the Treasury. It is our opinion that the timing, interest rates, terms, and conditions of any COSBI issuance of securities require the *approval* of the Secretary of the Treasury.

PARTICIPATION BY SBICS IN COSBI

In Section 7(e)(5), SBICs licensed and operating at the time of the enactment of the bill that elect not to qualify for COSBI and purchase the stock of COSBI will cease being SBICs. We do not think this is appropriate treatment since many SBICs have no intention of using leverage, are not hampered by the present regulatory structure, and thus do not need COSBI. Many SBICs have indicated that they do not support COSBI and that SBICs that do should pursue it on their own without effecting dissenting SBICs.

SBA AUTHORIZATIONS AND APPROPRIATIONS

The bill should be specific as to its intent with respect to Federal financial support for those SBICs that choose not to qualify, or for some reason cannot qualify for COSBI. It should make clear that SBICs choosing COSBI will not longer be refunded by SBA nor be eligible for any new SBA leverage, nor for the tax advantages presently available.

COSBI REGULATION OF SBICS

Section 9 of the bill relates to the contractual regulation of funds by COSBI but addresses only the conflict of interest issue. In our opinion, the bill should clearly spell out all regulatory matters to be included in such contracts for the protection of small business concerns.

TREASURY AUTHORIZATION TO PURCHASE COSBI OBLIGATIONS

The Treasury is authorized, in section 11(c), to purchase obligations of COSBI up to $1.0 billion at the discretion of the Secretary of the Treasury. The intent of this Section should be made clear on the face of the legislation including the boundaries of the Treasury's discretion. Use of funds derived from such purchases should be limited to protecting the credit standing of COSBI, and not be used for funding or refunding SBIC obligations to COSBI.

FINANCIAL FEASIBILITY

Even though COSBI has been compared to Fannie Mae, Sallie Mae, and Freddie Mac, and its structure made similar to those three quasi-Government corporations, there are significant generic differences between the SBIC securities contemplated to be assets of COSBI, and the obligations making up the assets of those three organizations.

The asset quality of COSBI, absent the SBA guarantee on the SBIC securites as is contemplated by the bill, will be speculative at best while the asset quality of those other organizations is investment grade. Therefore, we do not think that the optimistic estimates that COSBI borrowings will be at AAA or better rates are valid especially after the SBA guarantees expire which at the latest will be ten years from the date of the enactment of the legislation.

EFFECT ON OTHER SBA PROGRAMS

SBA is also concerned that, as drafted, this bill would, pursuant to its proposed section 3, repeal Sections 309(d) (authority to conduct hearings) and 310(a) (authority to conduct investigations) of the Act, thereby impairing the Agency's ability to investigate participants in and to conduct hearings involving the programs other than the SBIC Program covered by the Act—i.e., the Surety Bond Program, the Pollution Control Finance Guarantee Program, and the Sections 501, 502 and 503 Programs.

In summary, the issues discussed and commented upon herein are the major issues that we see at this time. Although many of the provisions of this bill are not acceptable to SBA, we are in agreement with the principle of privatizing the SBIC Program by truly privatizing the program or by satisfying our regulatory concerns.

The concept of replacing fully government-guaranteed financing of SBICs by financing techniques that would enable a meaningful and continuing participation by purely private investors has our support.

Thank you for the opportunity to comment on S. 2686 and we stand ready to discuss with you alternate provisions, or other proposals, that might make this bill acceptable, or otherwise accomplish its objectives.

The Office of Management and Budget advises that it has no objection to the submission of this report to the Congress.

Yours truly,

JAMES C. SANDERS,
*Administrator.*

Mr. MITCHELL. Thank you very much.

Congressman McDade has joined us. If you have an opening statement, Mr. McDade, we will take it now.

## OPENING STATEMENT OF HON. JOSEPH M. McDADE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. MCDADE. Thank you very much, Mr. Chairman. I first want to express my gratitude to you for scheduling these hearings on this very important matter. I am delighted, as you know, to be a cosponsor of the legislation. And I know the hearing will produce good information about where we are going to go from here.

We are glad that the agency is here; regretful that they are in a mode of opposing the bill. And we hope maybe we can bring the light of reason to you before we finish the hearing.

Thank you, Mr. Chairman.

Mr. MITCHELL. Thank you very much.

I have one or two questions that I would like to raise, and that is with reference to the role of the Treasury Department, which is kind of important in all of this.

What guidance or what advice did Treasury give you on the bill's section 354(c) provisions for the $500 million Treasury backstop? That is the line of credit. Did you get any advice?

Mr. TURNBULL. We have no specific guidance from Treasury at this time, Mr. Chairman.

Mr. MITCHELL. But was Treasury consulted on this issue?

Mr. TURNBULL. I did not personally consult Treasury. I know that we have been in touch with the Treasury Department, but not on this specific issue.

Mr. MITCHELL. All right. And as I recall, your statement, in my opinion, tends to overvalue the seed capital factor for COSBI. What is today's fair market value of MESBIC's outstanding preferred stock and debentures? Your statement values it at $225 million.

Mr. TURNBULL. $255 million, Mr. Chairman.

Mr. MITCHELL. $255 million. All right.

What is the fair market value?

Mr. TURNBULL. Perhaps Mr. Lineberry can answer that question better than I.

Mr. LINEBERRY. I cannot tell you precisely what the fair market value of the MESBIC outstandings would be. That $255 million represents the amount due to the Government.

We have not valued that preferred stock portfolio. I think that would be a very subjective thing.

We have valued, of course, on the other side, the SBIC debentures——

Mr. MITCHELL. Right.

Mr. LINEBERRY [continuing]. Based on current Treasury rates, and also looked at them based on current agency rates as well.

Mr. MITCHELL. Before we finish with the legislation, before we move it to markup would you get a chance to look at that again?

Mr. LINEBERRY. Yes; we could.

Mr. MITCHELL. I think that is kind of important.

Mr. TURNBULL. We would be glad to give you our best valuation on that.

Mr. MITCHELL. All right.

Mr. McDade, do you have questions?

Mr. MCDADE. Thank you, Mr. Chairman.

Welcome, all of you, and thank you for being up here at what we think is a very important hearing in which we attempt to privatize really a successful Government operation. These agencies have operated pretty well, have they not? Their track record, SBIC's and MESBIC's is pretty good, is it not?

Mr. TURNBULL. We believe it is a good program.

Mr. MCDADE. Yes; and I mean, the only difference between, it seems, the position that OMB has taken and the position that we are taking is that the exposure in the bill, the possible exposure of some kind of a Federal guarantee puts up a red flag and says to OMB that is reason enough to oppose the bill; is that about it?

Mr. TURNBULL. Well, Mr. Chairman, the SBA, as well as the Office of Management and Budget, is in opposition to the legislation because of cost factors mostly.

Mr. MCDADE. Define those a little more sharply for me, would you? What is it that causes the problem with respect to the amount that is outstanding in terms of resources back and forth?

Mr. TURNBULL. Let me talk a little bit about what we see as the cost factors here.

The sale of the Federal Financing Bank-held SBIC debentures to the COSBI entity would be at face value or par. There is, we believe, about a $150 million premium on that paper based on market value, based on what we know of the debentures in the portfolio. So that would be about $150 million—$161 million windfall right there.

The transfer of the $255 million in MESBIC assets without any sort of payback to the Government and, of course, the $100 million grant to the MESBIC Trust under COSBI from the purchase price of the debentures calls for about a $505 million capital investment originally, with the $500 million, of course, contingent injection from the Secretary of Treasury, as well as transferring the portfolio with SBA's continued liability or continued guarantee on the portfolio.

Mr. MCDADE. So your basic objection is to the level of valuation for the debentures, or whatever you want to call them, held in SBIC's or MESBIC's?

Mr. TURNBULL. Correct.

Mr. MCDADE. On the other hand, it would be true, would it not, that if we were able to proceed this way there would not be any kind of a demand on the Federal Government for any kind of financing on the successful program?

Mr. TURNBULL. The demand, of course, or possible demand would be on the Secretary of the Treasury to inject $500 million for continuing financing.

Mr. MCDADE. Yes; and we recognize that as a concern.

Is it not also true—and we discussed this just a minute ago—that both these programs have been highly successful, that they have worked well?

Mr. TURNBULL. We believe the SBIC and MESBIC Programs have.

Mr. MCDADE. Very little, very little problem of default, gross default with respect to the current mortgages, is that not right, or paper, whatever you want to call it?

Mr. TURNBULL. The loss rate we figure to be an ultimate loss rate of approximately 5.5 to 6 percent.

Mr. MCDADE. Which is an acceptable figure; is it not?

Mr. TURNBULL. That is the relative question.

Mr. MCDADE. Yes; well, you would think if a bank had 95–96 percent-ratio they would be managing the portfolio pretty well, would you not?

Mr. TURNBULL. Well, banks might not be willing to take those types of losses.

Mr. MCDADE. What is considered, let me find out if I can, what is considered a successful loss ratio?

Mr. TURNBULL. In this program it is very hard to tell, quite honestly, because this is a program that should be making equity investments or long-term loans to small businesses. It is very difficult to tell.

Mr. MCDADE. It is created to be a risk organization from day one.

Mr. TURNBULL. That is correct.

Mr. MCDADE. And so one would assume that an acceptable level of risks for this program would be higher than the normal one of, say, a guaranteed loan program or such—some other kind of program the Agency administers?

Mr. TURNBULL. Due to the nature of the fact that this is a venture capital program, the risk would probably be higher.

Mr. MCDADE. Is the 5- or 6-percent loan ratio specific? Do we know that that is the figure on COSBI's and MESBIC's?

Mr. TURNBULL. We know that on the SBIC paper in general. Right now we have an actual loss rate of 1.5 percent. We do have approximately $200 million in default. We would expect to recover about half of that, which would come to about 5.5 percent.

Mr. MCDADE. Yes; would you have any stats that would show, for example, the number of jobs created by the SBIC and the MESBIC programs?

Mr. TURNBULL. I do not believe that we have the statistics in house.

Bob, do we?

Mr. LINEBERRY. We have estimates. There are estimated numbers.

Mr. MCDADE. Do you have those now with you?

Mr. LINEBERRY. We do not have them. We could provide some numbers for the record. We have in the past, I think in the 1986 appropriations hearings, provided some numbers.

Mr. MCDADE. Fine.

With the permission of the chairman, we would——

Mr. MITCHELL. Yes.

Mr. MCDADE [continuing]. Like to have those for the record.

Mr. MITCHELL. Sure.

Mr. McDADE. Any idea how many new businesses were started through either SBIC or MESBIC activity?

Mr. LINEBERRY. Again, we can submit some numbers for the record.

Mr. McDADE. OK. It would be useful, I think, perhaps also if you could estimate, if you can, the amount of taxes paid into the Federal Government, as well as taxes, if records are kept, paid to State governments, local governments, et cetera, as a result of these two programs.

Mr. LINEBERRY. Well, again, those would be estimated numbers. But we will give you what we can on that.

Mr. McDADE. Appreciate it very much.

Mr. Chairman, that is all I have.

Mr. MITCHELL. Will you yield to me for——

Mr. McDADE. Sure.

Mr. MITCHELL [continuing]. For just a moment?

Mr. McDADE. Sure.

Mr. MITCHELL. In making your analysis, apparently you have not looked at the savings through the privatization. Our best estimate is $200 million over the next 5 years.

Right now you are financing MESBIC's at, what, $39 million a year. And it would seem to me if you can cost that out over 5 years you end up saving $200 million.

Were you aware of that dimension?

Mr. TURNBULL. Well, Mr. Chairman, I know there has been some disagreement between different parties about how this would be scored against the budget overall. My best estimate is we would be talking about a $500-million investment into this.

Mr. MITCHELL. Well, I will not belabor the point. I think there is a difference, an honest difference, in terms of how you approach this. But it is very clear that under privatization you would save—I am not addressing your other part—but you would save $200 million in 5 years.

Mr. McMILLAN. Would the gentleman yield?

Mr. MITCHELL. Yes; be delighted to yield.

Mr. McMILLAN. I think one other thing that should be considered in this is not just savings but the expansion of the potential of the purpose for which SBIC was created. And so the issue to me is not just a matter of savings, although that may be important, but this has been a good program so they are not likely to be that major, but the real question is by privatization do we enable COSBI to generate a larger pool of capital, venture capital in this country for small business. And that, to me, is the key issue and I think the primary appeal of this legislation.

Mr. MITCHELL. Thank you.

Mr. Slaughter, do you have questions?

Mr. SLAUGHTER. No questions.

Mr. MITCHELL. Do you have additional questions?

Mr. McMILLAN. No.

Mr. MITCHELL. Gentlemen, thank you.

We are under a very tight timetable. And I would hope that that additional information we asked for would—or Congressman McDade asked for would be submitted as expeditiously as possible. The legislative clock is ticking.

And thank you very much for being here.

Mr. TURNBULL. I understand, Mr. Chairman. Thank you very much for having us.

Mr. MITCHELL. Thank you, gentlemen.

[Additional material follows:]

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

JUL 11 1986

Honorable Parren J. Mitchell
Chairman
Committee on Small Business
House of Representatives
Washington, D.C. 20515

Dear Chairman Mitchell:

This letter transmits to you information which was requested by Committee members and staff at the June 24, 1986, Hearings on H.R. 5019, the Corporation for Small Business Investment Charter Act.

SBA's Estimate of the Value of the SBIC Portfolio. In SBA's testimony an estimate was made of the windfall to COSBI resulting from its purchase of the SBA-Guaranteed SBIC Debentures from the Federal Financing Bank at par rather than value. We were requested to give an explanation of the method used to reach that estimate. Attached is an Evaluation Summary which provides the data, and the analytical basis and procedures used to make that estimate.

Market Value of the MESBIC Portfolio. It was requested that we provide an estimate of the value of the MESBIC preferred stock and debentures that would be granted by SBA to the COSBI MESBIC Trust should the bill in its present form become law. Estimating that value is subject to various assumptions that we are not able to make with any certainty. In the alternative, we are attaching a discussion of the financial effects of the proposed grant and conveyance of that portfolio.

Job Creation Data. We were requested to provide data on the jobs created in the SBIC and MESBIC programs. We do not have current valid job creation statistics to supply to you.

Number of Business Start-Ups. Data was requested on the number of business start-ups that were financed by the SBIC and MESBIC programs. Attached hereto is a table that shows the number and dollar amount of financings which were provided to small concerns whose age at the time of the financing was less than one year old. These financings are a valid proxy for start-up financings.

Taxes Generated at All Levels. We were asked to supply data on the amount of taxes that are generated by the SBIC and MESBIC programs at all levels. Attached is a table showing the taxes paid by SBICs and MESBICs since 1976. We do not have data on the taxes paid by the small concerns financed by SBICs and MESBICs.

We trust this information is responsive to the Committee's requests and stand ready to provide additional information should it be needed.

Sincerely,

Robert A. Turnbull
Associate Deputy Administrator
for Management and Administration

Enclosures

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

# EVALUATION SUMMARY

## Financial Effects of the Sale of SBA-Guaranteed SBIC Debentures to COSBI by the FFB at Par (Face) Value

Estimate of Treasury Financial Loss

| | |
|---|---|
| Cost of Redemption of Matching Treasuries | $ 1,216,188,254 |
| Minus : Par (Face) Value of Debentures | 1,034,994,900 |
| Equals: Estimated Treasury Loss | $ 181,193,354 |

Estimate of COSBI Gross Financial Advantage

| | |
|---|---|
| Present Value of Debentures | $ 1,201,139,923 |
| Minus : Par (Face) Value of Debentures | 1,034,994,900 |
| Equals: Estimated Advantage to COSBI | $ 166,145,023 |

(This estimated advantage would be diluted due to the downward effects on the present value of the differences in characteristics between the Debentures and other seasoned Agency securities, and because of exposure from SBA of prepayment at par.)

Sensitivity to Increases in Yields

( $ in Millions)

| * Treasury Rate Change From | To | Change In Treasury Loss | * FNMA Rate Change From | To | Change In COSBI Advant. |
|---|---|---|---|---|---|
| 7.64 | 8.64 | - $ 43.5 | 7.93 | 8.93 | - $ 42.4 |
| 8.64 | 9.64 | - $ 40.9 | 8.93 | 9.93 | - $ 39.9 |
| 9.64 | 10.64 | - $ 38.4 | 9.93 | 10.93 | - $ 37.5 |
| 10.64 | 11.64 | - $ 36.2 | 10.93 | 11.93 | - $ 35.3 |

* Based on average yields

ANALYTICAL BASIS AND PROCEDURE

Analytical Basis. In the absence of law requiring a sale at the Debentures at par (face) value, to assure that the sale of the Debentures to COSBI would be a financially neutral transaction to the Treasury (that is, no gain or loss), the Treasury would price the Debentures on the basis of the cost to the Treasury to redeem with the proceeds of the Debenture sale, a like and matched amount of Treasury obligations in the marketplace.

Should the Congress pass H.R. 5019 (COSBI Charter Act) with provisions requiring the sale of the Debentures at par (face) value, then the loss to the Treasury would be equal to the difference between the present value of the Debentures at current Treasury market rates (yields) and their par (face) value.

The advantage to COSBI, however, would be less than the loss to the Treasury from such a par sale. This is so because the Debentures once purchased will join the class of securities known as Agency securities. Because of the differences in risk and liquidity, Agency securities have higher yields (and thus lower prices) than Treasury securities. It is for this reason that the advantage on the purchase of the Debentures will not exactly match the loss sustained by the Treasury should the sale be required at par.

There are several reasons why the Debentures might not be as valuable as a matched amount of Agency securities. First, the Debentures are a new security and it would take time for the investment community to become familiar with them and to follow them. Next, the Debenture will not initially be as liquid since there will not be a developed secondary market and the absolute volume of securities outstanding will be limited. Finally, the Debentures are subject to be repurchased before maturity at par by SBA. This would cause a loss to any holder of the amount of any premium above par paid for the security. Historically, such prepayment by SBA has been 35 % of the outstandings.

Analytical Procedure. To evaluate the financial effects of such a par sale it was necessary to compute the present value of the cash flow of the FFB's (Treasury's) portfolio of Debentures using as discount factors the yields from both the Treasury securities yield curve and the Agency securities yield curve. Since there is no single Agency yield curve, the Federal National Mortgage Association (FNMA) yields were used as a proxy.

The steps in the computation of the present value of the portfolio of Debentures using those two sets of yields were as follows:

1. the monthly dollar cash flow of principal and interest on the outstanding portfolio was scheduled; then,

2. using the Treasury and FNMA yield curves as published in tabular form in Barron's, each monthly dollar cash flow was matched with its applicable Treasury and FNMA yield; then,

3. the present value of each month's principal and interest cash flow was computed using the respective Treasury and Agency yields as in 2. above as discount factors; then,

4. the present values arrived at in 3. above were added to arrive at the total present values; then,

5. the present values arrived as in 4. above were compared to the par (face) value of the portfolio to arrive at the loss to the Treasury, and the gross advantage to COSBI.

Treasury Financial Loss/COSBI Gross Advantage. Using the procedure described above, following is a summary of the estimate of the Treasury financial loss and COSBI advantage from a par sale.

Estimated Treasury Loss

| Cash Flow | Par (Face) Value | Present Value |
|---|---|---|
| Principal | $ 1,034,994,900 | $ 712,237,099 |
| Interest | 643,277,063 | 503,951,155 |
| Total | $ 1,678,271,963 | $ 1,216,188,254 |
| Present Value of Total Cash Flow | | $ 1,216,188,254 |
| Minus: Par (Face) Value of Debentures | | 1,034,994,900 |
| Equals: Estimated Treasury Loss | | $ 181,193,354 |

Estimated COSBI Gross Advantage

| Cash Flow | Par (Face) Value | Present Value |
|---|---|---|
| Principal | $ 1,034,994,900 | $ 700,666,922 |
| Interest | 643,277,063 | 500,473,101 |
| Total | $ 1,678,271,963 | $ 1,201,139,923 |

| | |
|---|---|
| Present Value of Total Cash Flow | $ 1,201,139,923 |
| Minus: Par (Face) Value of Debentures | 1,034,994,900 |
| Equals: Estimated COSBI Gross Advantage | $ 166,145,023 |

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Discussion of the Financial Effects of the Grant and Conveyance to the COSBI MESBIC Trust of SBA's MESBIC Preferred Stock and Debentures

## Effects on the Government

Continuing Cash Disbursements. At the end of calendar year 1985, SBA held MESBIC preferred stock and debentures with outstanding face value of $ 255.3 million. These securities were acquired with funds supplied by the process of budget authorization, appropriation, and allocation.

It is reasonable to assume that to fund this process the Treasury borrowed funds at prevailing market interest rates and for a term matching to the extent possible the life of the assets acquired.

Notwithstanding the provisions of any future COSBI Charter Act, the Treasury must continue to service its obligations issued to finance the MESBIC budget, and to ultimately redeem or rollover the securities so issued. Thus, from a cash flow standpoint, the MESBIC program will continue to be a drain on the Treasury.

Chargeoff of Assets. Should the COSBI Charter Act require the grant and conveyance of the SBA's $ 255.0 million of assets to the COSBI MESBIC Trust, that grant and conveyance would be an irrevocable gift and thus SBA will be required to charge off that amount in full since it no longer will have legal title to, nor any beneficial ownership of, those assets.

No Future Government Funding. The basic consideration for such grant and conveyance ( and for an additional $ 100.0 million of cash grant) as contemplated by the COSBI Charter Act would be that the Government would no longer authorize nor appropriate additional funds for MESBICs. Based upon a program level of $ 40.0 million per year, various calculations of savings could be made using different assumptions about discount rates and years of remaining program life.

Effects on the CONBI MESBIC Trust

Value of the Preferred Stock. The purchase of the 3% preferred stock by SBA from MESBICs represents a subsidy contemplated by the authorizing legislation to provide the MESBICs with a cushion for the risks they are taking in the financing of businesses owned by socially or economically disadvantaged persons. As a practical matter, the purchase of preferred stock by SBA represents an up-front grant subject to recovery only if the MESBIC fails to perform its obligations under the Small Business Investment Act, and the SBA's regulations.

The preferred stock outstanding of $ 173.6 million is presently yielding slightly less than one-half of one percent (0.5%). It is not contemplated that any of the preferred stock will be redeemed voluntarily although SBA may be able to recover some of its funds in liquidating failed MESBICs.

Computing the value of the preferred stock is not possible with any accuracy since the variables necessary for that computation are not known values and their estimation is speculative at best.

Value of the Debentures. These securities held by SBA can be valued using standard procedures. The calculation of the cash flow of this portfolio of approximately $ 82.0 million is a complex analytical process that we have not as yet undertaken. We would estimate that these securities have a value equal to their face value minus a default rate of about 20%. That default rate, we feel, will be increasing as the Debentures age and their subsidy periods expire.

These securities as a portfolio yield 9.74 % at the present time and that yield would be available for the operations of the trust. However, these are assets owned but not guaranteed by the government, and their sale would not be likely to generate a windfall.

Small Businesses Less Than One Year Old

Financed by Regular SBICs

| Calendar Year | Number of Financings | Percent of # of Financings | Dollar Amount | Percent of Financing $ |
|---|---|---|---|---|
| 1976 | 605 | 35.17 | $45,030,780 | 34.80 |
| 1977 | 756 | 36.50 | $71,251,185 | 34.53 |
| 1978 | 834 | 39.96 | $93,346,895 | 40.13 |
| 1979 | 884 | 39.17 | $111,723,760 | 39.89 |
| 1980 | 755 | 36.12 | $111,822,380 | 37.88 |
| 1981 | 932 | 38.29 | $137,558,620 | 41.35 |
| 1982 | 760 | 34.91 | $121,048,061 | 37.49 |
| 1983 | 807 | 32.75 | $141,104,719 | 34.17 |
| 1984 | 894 | 32.45 | $156,387,144 | 36.75 |
| 1985 | 1,017 | 36.90 | $165,038,744 | 37.98 |
| 10 Year Total | 8,244 | | $1,154,312,288 | |

Financed by 301(d) SBICs

| Calendar Year | Number of Financings | Percent of # of Financings | Dollar Amount | Percent of Financing $ |
|---|---|---|---|---|
| 1976' | 152 | 44.19 | $6,069,325 | 44.46 |
| 1977 | 167 | 38.04 | $9,930,446 | 43.95 |
| 1978 | 258 | 55.72 | $19,451,232 | 60.81 |
| 1979 | 204 | 46.26 | $19,042,394 | 54.25 |
| 1980 | 234 | 42.78 | $20,781,381 | 49.28 |
| 1981 | 422 | 56.87 | $31,500,421 | 57.95 |
| 1982 | 376 | 49.21 | $23,668,760 | 50.38 |
| 1983 | 386 | 49.30 | $27,328,725 | 48.90 |
| 1984 | 638 | 51.66 | $45,529,382 | 51.42 |
| 1985 | 662 | 45.69 | $44,709,557 | 41.53 |
| 10 Year Total | 3,499 | | $248,011,623 | |

## Taxes Paid by SBICs

### Regular SBICs

| Fiscal Year | Taxes Paid on Investment Income | Taxes Paid on Capital Gains |
|---|---|---|
| 1976 | $574,389 | ($2,340,586) |
| 1977 | $133,489 | $68,935 |
| 1978 | $675,178 | $4,328,795 |
| 1979 | $3,076,798 | $11,193,052 |
| 1980 | $6,265,215 | $11,204,455 |
| 1981 | $6,061,086 | $15,449,099 |
| 1982 | $6,964,708 | $39,326,402 |
| 1983 | $2,351,512 | $22,869,539 |
| 1984 | ($3,733,377) | $33,047,039 |
| 1985 | ($8,560,749) | $31,074,366 |
| 10 Year Total | $13,808,249 | $166,221,096 |

### 301(d) SBICs

| Fiscal Year | Taxes Paid on Investment Income | Taxes Paid on Capital Gains |
|---|---|---|
| 1976 | $111,964 | $32,287 |
| 1977 | $134,981 | ($78,701) |
| 1978 | $350,823 | ($240,271) |
| 1979 | $623,572 | $113,450 |
| 1980 | $788,368 | ($28,178) |
| 1981 | $1,668,995 | ($382,475) |
| 1982 | $2,518,002 | ($853,136) |
| 1983 | $2,057,696 | ($513,148) |
| 1984 | $1,787,067 | ($1,322,452) |
| 1985 | $1,295,061 | ($73,247) |
| Ten Year Total | $11,336,529 | ($3,345,871) |

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Mr. MITCHELL. Is Mr. Samuel Adams here yet?
[No response.]
Mr. MITCHELL. I do not see Mr. Adams. I know that his testimony will be forthcoming. And we will simply submit that for the record.
[Mr. Adams' prepared statement, with attachments, follows:]

PREPARED STATEMENT OF SAMUEL W. ADAMS, LEGISLATIVE REPRESENTATIVE, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. Chairman, my name is Sam Adams and I am a Legislative Representative with the National Federation of Independent Business (NFIB). On behalf of the more than 500,000 small firms that comprise NFIB, I'd like to thank you for this opportunity to testify on H.R. 5019, the Corporation for Small Business Investment Charter Act.

NFIB has supported the concept of the Corporation for Small Business Investment (COSBI) from the outset, and we are pleased to be able to endorse this legislation. We commend you for your efforts on behalf of COSBI, particularly for the revisions in this latest draft that resolve many of the concerns raised by the SBA and others with an interest in the bill. We are optimistic that the COSBI Charter Act will become law during this Congress, providing an important new facility for warehousing and secondary market sales of SBIC obligations.

NFIB's support for H.R. 5019 is predicated on three key elements of the bill: its budgetary consequences, its effect on the government's role in the small business credit marketplace, and its impact on the Small Business Investment Company (SBIC) community. I would like to take a few moments to discuss each of these components from our perspective, and to address the concerns we have about the bill.

The most important legislative issue for the membership of NFIB has been--and remains--the size of the federal budget deficit.

Small-business owners believe that the deficit should be reduced through spending reductions, with an increase in taxes only as a last resort. This perspective has brought upon us the need for hard decisions about the nature and scope of many federal programs. Certainly the Small Business Administration itself has been the subject of much debate and deliberation in this regard. Yet while many have looked upon this period of fiscal restraint as one increasing the limitations on what government can do to assist small firms, NFIB has viewed this time as one presenting unique opportunities for reforming and improving programs aimed at small business development. In short, we feel that the need for deficit reduction and the need for a strong and independent agency to represent small business can be reconciled through reforms at the SBA.

It is with the foregoing in mind that NFIB again devised a reform proposal for the SBA this year: (a copy of this proposal is here submitted for the record). An important part of this proposal is the establishment of a government-sponsored corporation to provide a well-defined and permanent secondary market for the SBICs. As it is currently drafted, this bill would provide for the establishment of such a corporation, which would relieve the government of financing obligations for the SBICs in the near term, and do so for the MESBICs in the long term. Conservative estimates indicate that purchase by NSBI of the outstanding SBIC debentures

now held by the Federal Financing Bank (FFB) and due to mature in 1988 or thereafter would yield a one-time budgetary savings of $700 million. If USBI were to become operational in 1987, the Act empowers it to purchase debentures maturing before 1988, which might yield an additional $100 million in savings. These savings, coupled with annual appropriations not made as a consequence of the Act, provide the most important basis for NFIB's support.

It is quite clear, however, that the debate over the future of the SBA has never been purely budgetary in nature. Rather, lying at the heart of proposals to eliminate or programmatically emasculate the agency, has been the fundamental policy issue of the government's role in the small business credit marketplace. In this matter NFIB has stood between those who feel that the government's current role is appropriate and those who feel that its intervention ought to be eliminated entirely. NFIB believes that a vacuum does exist in the credit market for long-term financing for small firms, and concludes further that the SBA can be useful in assisting private capital providers to fill that vacuum. It is our firm conviction, however, that the government's role in assisting capital flows must be as discreet as possible, with the most appropriate participation being in the form of guarantees or Treasury backstops. Such limited involvement minimizes the harmful effects of government presence in the free market, while leveraging scarce budget resources toward the desired end. In this regard, the creation of USBI would significantly reduce--though not eliminate--

government involvement in the provision of capital to small firms through SBICs. NFIB looks with favor on any reform that reduces government intervention without reducing program efficiency; the COSBI proposal promises to meet this criterion. In addition, it may prove possible to reduce further the government's involvement with the program once COSBI has established a track record worthy of greater trust on the part of investors.

Critics of the COSBI concept have frequently--and correctly--noted that the legislation would not fully privatize the SBIC and MESBIC programs. They cite continued oversight powers of the SBA over these companies and the continued financial obligation of the government (especially in the case of MESBICs) as evidence of an ongoing federal role. However, it must at last be conceded that the Administration's effort to eliminate this program (and much of the rest of the SBA) has not been met with congressional enthusiasm. This being the case, it would seem prudent for advocates of limitations on government involvement in the credit markets to take what they can get, viz. a substantially reduced federal role in the SBIC programs. Because while the Treasury backstop line of credit contained in H.R. 5019 may be noxious to government intervention purists, its implicit value is nothing compared to the explicit value of annual appropriations and a sizable portfolio of SBIC debentures at the FFB. Thus, while NFIB might agree in principle with the critics of COSBI on this point, practical politics dictate accepting this reform proposal on its own merits.

The final reason NFIB supports H.R. 5019 is the benefits that would accrue to the SBICs themselves and, through them, to small firms across the nation. For over 25 years the SBICs have been hard at work trying to operate profitably while filling their congressional mandate: to provide a source of long term debt and equity capital for small businesses. The success of their efforts is best recounted by the SBICs and their representatives, but suffice it to note here that the program stands as valuable proof that public-private partnerships can accomplish what public or private initiatives may not be able to do severally. Today over 500 SBICs are in operation, and the National Association of Small Business Investment Companies (NASBIC) tells us that these entities have invested over $5 billion in more than 66,000 small firms since 1958. SBIC-financed firms have growth rates ten times greater than other small firms and produce new tax revenues at a five-fold greater rate. Estimates balancing actual federal outlays for the SBIC program against new revenues generated show a cost-benefit ratio of 1 to 110. Clearly the work of the SBICs should be continued.

In spite of the success of the SBIC and MESBIC programs, their federal funding has not been consistent nor their fate secure. Even during periods of relative budgetary plenty, appropriations for SBIC leverage have run dry. It is well known that during the current budget crisis the SBIC programs (among other SBA credit activities) have been targeted for complete elimination. Thus the need for establishing COSBI has become all the more pressing; without it

funding for the SBICs will not be merely inconsistent, it will be nonexistant.

NFIB supports the establishment of COSBI on the realistic assumption that doing so would provide a permanent framework for the warehousing and sales of SBIC obligations. This is important for two reasons: first, SBICs and MESBICs would be certain of a marketplace for their debentures; second, COSBI would maintain and expand the critical nexus between large institutional investors and individual small businesses. These effects would create a more standardized procedure for the management of SBIC paper and would open up vast opportunities for the securitization of that paper. Rather than warping or thwarting the free market flow of capital, COSBI would provide the economic intelligence and market connection necessary to emancipate capital so that it could flow more easily to small firms. This is clearly in the interest of the SBICs, the investors, and the large number of small firms that desperately need long-term capital.

Lest we be naive about the nature of the federal government's present commitment to the SBICs and its future one, let there be no mistake: government involvement will persist, and to the extent it does, a subsidy--explicit or implicit--will also persist. Compare the cost of this subsidy, modest in the near term and virtually without cost thereafter, to the massive subsidies afforded larger businesses through the investment tax credit, to farms through price

supports, and to the housing industry through mortgage interest deductions. The implicit value of the Treasury backstop is theoretical and minimal next to the hard subsidies provided these other smaller economic sectors. Given the track record of the SBICs and the evidence of their new revenue generation, the implicit subsidy involved in the COSBI proposal is extremely modest. Arguments against it pale when the success of other similar government sponsored corporations (such as those serving the home mortgage industry) is considered.

NFIB's endorsement for COSBI is not without reservations. As suggested earlier, a completely privatized SBIC program would be ideal. Recognizing, however, the limitations both political and economic to such a course, we endorse H.R. 5019 in its present form. An additional concern of NFIB's is that, as the government's involvement is phased down, the mandate of the SBICs should not be diminished. In particular, NFIB is concerned that a broad range of small firms seeking long term capital be able to obtain it through the SBICs--not just those firms that promise unusual growth or that have very large capital needs. NFIB has found that the vast majority of existing small firms use commercial lenders for their long term capital needs--and still there is excess demand for such capital. SBICs, particularly through the creative use of equity financing, offer another avenue for obtaining this capital. NFIB hopes that COSBI can provide a means for expanding the depth and range of SBIC and MESBIC capital provision.

Ultimately, the success of the SOSBI initiative will depend upon the reception that SOSBI securities receive in the marketplace. NFIB is optimistic that the SOSBI charter as framed in this legislation bodes well for the creation of a stable and workable intermediary for the SBIC industry. We look forward to supporting H.R. 5019 as it works its way through the process.

NFIB Proposal

Introduction

The reconciliation bill, which has not yet been passed by Congress, contains many of the SBA reforms we advocated in our 1985 proposal. These reforms amount to $2.5 billion in budget savings over three years.

The following proposal expands upon our 1985 efforts. If the proposal were to be enacted as is, over $1 billion would be saved within two years.

Proposal

1. Elevate the SBA Administrator to a Cabinet Level Position

2. Program Restructuring

A. Make Guaranteed Loans Self-Sustaining

SBA guaranteed loans can be made self supporting by reducing the amount of loan authority and increasing the guarantee fee. The assets in the Business Loan and Investment Fund would be placed in a trust, and the income from that trust would pay for defaults.

Current assets to be put in the trust amount to $2,199,000,000, to be comprised of the following:

| | |
|---|---|
| -Performing direct loans | $960 million |
| -Performing repurchased guarantees | $220 million |
| -Delinquent and liquidation direct loans at one-half book value ($527) | $264 million |
| -Delinquent and liquidation guaranteed loans at one-half book value ($1,507) | $754 million |

Income generated by the trust would be about $250 million (1985 estimate). Losses normally run about 10%, which this income would cover. If another 5% of guarantees made were added for error, $250 million would run a $1,667,000,000 guarantee authority program.

Note: Currently the guarantee program is authorized at $3.2 billion. The reduced level of our proposed program would probably require more stringent size standards for loans, to tighten eligibility and ensure that smaller businesses that really need long-term credit benefit from the program.

By increasing the guarantee fee from 1% to 3.5% of the loan amount, $58 million will be generated to cover the cost of administering the entire F & I program (including SBICs, MESBICs, and 503s).

**Savings:** $160 million per year beginning one year after enactment.

Note #1: The reconciliation package includes a guarantee fee increase from 1% to 2%, generating $64 million from the $3.2 billion-authorized level. Our proposal generates $58 million on a $1.6 billion program.

Note #2: Reduction in the size of the guarantee program should allow for reduction in the number of loan officers; the savings from salaries and expenses could be put into the trust to increase the loan guarantees.

Note #3: If some SBA field offices are closed, F & I employment would decrease further.

Note #4: Once the program is self sustaining, greater reliance on the certified and preferred lenders should allow for eventual privatization of the guarantee program, with SBA's role limited to an auditing function. F & I employment could be further reduced, and the program would operate almost entirely in the private sector.

(This proposal and others share a common goal: to provide services at reduced cost. We should remain flexible as to which proposal ultimately is considered most efficient and most feasible.)

B. Privatize Funding for SBIC, MESBIC, and 503

$691 million in Federal debt is generated by these programs each year. Debentures issued by the companies should be required to be sold to private investors rather than the Federal Financing Bank.

Savings: $691 million per year, beginning one year after enactment.

Note: The reconciliation package includes this requirement for all SBIC debentures and some 503 debentures, amounting to a savings of $391 million. Our porposal would fully implement the requirement, raising an additional $300 million in savings.

3. Program Termination

End direct loans.

Note: We were partially successful last year in this effort, with both committees agreeing to reduce direct loan authority by about half (from $257 million).

4. Program Reductions

A. Management Assistance
Terminate all management assistance programs. In their place, substitute a $15 million demonstration grant program to help state and local entities fund novel small business development projects (incubators, enterprise zones, etc.).

Savings: $30 million per year after first year.

B. Special Programs
Terminate veterans, women, and international trade programs. Keep only the Small Business Advisory Board.

Savings: $3 million per year after first year.

C. Advocacy
Terminate regional advocates.

Savings: $1 million per year after first year.

5. Program Relocations
A. Move pollution control bond guarantee programs to EPA. EPA requires the bonds, so it makes sense to give them the program that enables small firms to fulfill the requirements.

B. Move minority programs to Commerce to consolidate like functions within one agency.

Note: If this proves to be politically infeasible, the MBDA program in Commerce could be moved to the SBA.

6. Program Retention
A. Procurement Assistance
B. Surety Bond Guarantee Program
C. SBIR Program

All these programs are low-cost items which have proved to be efficient and necessary. All more than pay for themselves and should be retained as is.

7. Additional Considerations

A. Disaster Loans

If the reconciliation passes, the reforms we advocated last year--eliminate non-physical disaster loans and farmer eligibility for disaster loans--will have been achieved. If the bill does not pass, we must add these items to our new proposal.

In addition, the restructuring and eventual privatization of the guarantee program weakens the justification for keeping a cadre of specialized disaster loan officers in SBA. The disaster loan program should therefore be relocated within another agency.

NFIB Proposal Page Four

Conclusion

If the proposal is enacted as is, budget savings would be achieved as follows:

| | In millions |
|---|---|
| Self Sustaining Guarantees | $160 |
| Private Financing (SBIC, MESBIC, 503) | $691 |
| Direct Loan Termination | $150 |
| Guarantee Fee Increase | $ 58 |
| Salary and Expense Reduction | |
| Management Assistance | $ 30 |
| Advocacy | $ 1 |
| Special Programs | $ 3 |
| TOTAL | $ 1,093 |

If reconciliation passes, the budget savings from this proposal would be reduced by $391 million. This amount is already included in the SBA reconciliation package, since all SBIC and part of 503 debentures are required to be purchased by private investors. As a result, total savings from this proposal would be $702,000,000.

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Chart I

Loan Activity 1985 FY

| | Number | Dollars |
|---|---|---|
| All Directs | 1985 | $ 122.1 |
| 7A-general business | 1419 | $ 84 |
| EOL | 328 | $ 16 |
| Handicap | 237 | $ 22 |
| Energy | 1 | $ .1 |
| | | |
| All Guarantees | 17,290 | $2,667 |
| 7A-general business | 15,422 | $2,315 |
| EOL | 430 | $ 43 |
| 503 | 1, 430 | $ 307 |
| Handicap | 5 | $ .8 |
| Energy | 3 | $ .8 |

Chart II

Year End

FY 85

Portfolio

In Millions

| | Number | Amount | Current | Delinquent | Liquid | % |
|---|---|---|---|---|---|---|
| Disaster Revolving | 230,628 | $4,643 | 184,589/$3,407 | 16,868/$349 | 11,431/$ 561 | 11% |
| Business Revolving | 130,101 | $11,340.8 | 96,777/$8,420 | 7,893/$595 | 18,754/$1,811 | 16% |
| 503 | 2,709 | $253 | 2,709/$212 | 109/$12 | 192/$21 | 8.25% |
| All Direct | 31,787 | $1,487 | 21,082/$960 | 3,037/$133 | 5,260/$287 | 19.29% |
| All Guarantee | 81,827 | $9,854 | 75,695/$7,460 | 4,856/$462 | 13,494/$1,524 | 15.49% |

Chart III

NFIB Proposal

Savings Recapitulation

| | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|
| Private Fiancing | | | | |
| SBIC | 250 | 250 | 250 | 250 |
| MESBIC | 41 | 41 | 41 | 41 |
| 503 | 400 | 400 | 400 | 400 |
| Guaranteed Loans | 160 | 160 | 160 | 160 |
| No Directs | 150 | 150 | 150 | 150 |
| Raise Guarantee fee | 58 | 58 | 58 | 58 |
| Management Assistance | 30 | 30 | 30 | 30 |
| Advocacy | 1 | 1 | 1 | 1 |
| Special Programs | 3 | 3 | 3 | 3 |
| | $1,093 | $1,093 | $1,093 | $1,093 |

Mr. MITCHELL. We will resume hearings tomorrow, at which time we will hear from Mr. Hill, the chairman of the American Association of Minority Enterprise, Small Business Investment Companies; and Mr. Thomas Noojin, the National Association of Small Business Investment Companies.

Let me go on record as issuing one warning signal right now. We had our Small Business Investment—Small Business Innovation and Research bill scheduled for floor action under the Union Calendar on last Monday. That was a bill that I think came out of our committee unanimously; all of us were in favor of it. It is another successful program.

However, to my surprise, that bill has been sequentially referred to six different subcommittees. Now, the sequential referral I do not think will exceed 30 days. I think that is the limit on it.

And there is always the danger because they have implications for other committees of the Congress, there is always the danger of a sequential referral. We shall strive very hard to avoid that.

Thank you very much for being here. We will see some of you again tomorrow morning at 10 o'clock.

Mr. MITCHELL. This hearing is now recessed until tomorrow at 10.

[Whereupon, at 10:20 a.m., the subcommittee adjourned, to reconvene at 10 a.m., Wednesday, June 25, 1986.]

# CORPORATION FOR SMALL BUSINESS INVESTMENT

WEDNESDAY, JUNE 25, 1986

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON SBA AND SBIC AUTHORITY, MINORITY ENTERPRISE AND GENERAL SMALL BUSINESS PROBLEMS, COMMITTEE ON SMALL BUSINESS,

*Washington, DC.*

The subcommittee met, pursuant to notice, at 10 a.m., in room 2359-A, Rayburn House Office Building, Hon. Parren J. Mitchell (chairman of the subcommittee) presiding.

Mr. MITCHELL. Good morning. The hearing will now come to order.

We will conclude our hearings this morning on H.R. 5019, the Corporation for Small Business Charter Act.

Yesterday, we had testimony from the Administration which, unfortunately, at the present time does not support the legislation, even though it would carry out two of its prime objectives for privatizing the providing of venture capital and the reduction of Government spending.

Today we are receiving testimony from representatives of the SBIC industry, Mr. Duane Hill as chairman of AAMESBIC and Mr. Thomas Noojin as chairman of NASBIC.

The House went in session at 10 a.m. That is the first vote, probably to approve the journal. I will sort of ignore that one and make it up later on. We are in session and I will try to move the hearing along as rapidly as I can.

Both of our witnesses, or all three of our witnesses, are in place. We have your prepared testimony. We are very grateful for that. That entire testimony will be included in the record. If you can summarize your testimony I would be most appreciative. I think the other members of the committee will, too.

Mr. Hill, will you lead off for us, please.

## TESTIMONY OF DUANE E. HILL, CHAIRMAN, AMERICAN ASSOCIATION OF MINORITY ENTERPISE SMALL BUSINESS INVESTMENT COMPANIES, ACCOMPANIED BY HERBERT WILKINS, PRESIDENT, SYNCOM CAPITAL CORPORATION

Mr. HILL. Good morning, Mr. Chairman and members of the committee. And thank you.

I am Duane Hill, president of Equico Capital Corp. in New York, and chairman of the American Association of Minority Enterprise Small Business Investment Companies, or AAMESBIC. And I am

happy to be joined this morning by my colleague Herb Wilkins. Herb is president of Syncom Capital Corp., a MESBIC here in Washington, DC. He is also former chairman of AAMESBIC, and currently chairman of the AAMESBIC Legislative Committee and chief architect of the trust feature in the proposed legislation.

We are both pleased to be here to testify in support of H.R. 5019, to create COSBI. I am also pleased to note that the bill enjoys the cosponsorship of 38 members of the committee. I think this is an indication that the committee feels, as we do, that this is an innovative and financially sound way of providing for the continuing operations of MESBIC's and SBIC's.

I think the last time we testified here at the committee we talked a little bit about my background and what I do. So I do not think we need to repeat that again, Mr. Chairman.

I will suffice to say that Equico Capital, the company which I manage, has been in existence almost since the beginning of the program in 1971. The Equico, along with several other large corporations, responded to the call from the then Nixon administration to provide funds for investing in minority-owned small businesses. And this was the genesis of the MESBIC Program.

The program has grown considerably over the years. In those early years some of the first investments were as little as $13,000. The average investment these days is in excess of $100,000. The total investments in the industry amounted to $2.2 million back in 1971; in 1985 there were investments of almost $108 million. So the industry has grown considerably since then.

And I think it is fair to say that we were a leader in the financing of minority small businesses. Any list of prominent minority-owned businesses will include a number of companies that were financed by MESBIC's. And contrary to some of the views that have been stated by the administration and the SBA, there are not similar sources of venture capital available to the companies we finance.

I think, as most of you know, equity venture capital provided for developing business frequently, comes from friends and relatives and wherever else you can get it. And in the minority community there continues to be this equity gap. I think the MESBIC's in particular play a very important role in filling that equity gap in the minority community. So it is certainly important that we continue to have a thriving MESBIC industry as long as we have that gap.

I might point out a couple of our success stories. I think everyone is familiar with Essence magazine, which was financed by MESBIC's. In addition to providing capital for small businesses, I think our capital allows them to get capital from other sources as well. And an important example of that is the Connection Communication Corp., which is the company that owns the cable television franchise in Newark.

Back in 1982, that company was financed by a syndicate of 10 MESBIC's who provided $2.5 million in equity and near equity capital. That enabled Connection to go and borrow an additional $4 million from a major insurance company and $3 million from a bank, to provide a total of $9.5 million to build that system. And that system now provides cable TV to 25,000 subscribers in the

community of Newark. And so, it has been a real service to the community and provided a number of jobs.

That is just one indication of the kind of successes that we think that the MESBIC industry provides. I think it is a clear indication of where we can fill that equity gap, because, clearly, the entrepreneurs who are responsible for building and managing that system would not have been able to have built and acquired that system without the equity capital provided by the MESBIC's.

I cite these examples to demonstrate that we have been successful. In the testimony, we mention a number of companies that indicate that we do finance a variety of different kinds of companies in different industries and different ethnic groups. And so there is a fairly broad base of the kind of companies that we finance.

Between 1978 and 1985, we invested over $462 million in some 5,000 minority-owned small businesses. These same companies produced over $4.5 billion in revenues and created over 82,000 jobs. Last year alone, our investments resulted in the creation of $100 million in tax revenues.

We have made a lot of progress since the origins of the MESBIC industry. And so, one might legitimately raise the question, if we are doing so well and accomplishing all these great things, why do we need COSBI?

I think the one overriding answer to that question is that we need stability in the industry. It is absolutely essential as providers of long-term capital that we have a stable funding source and we reduce the uncertainty that we have been confronted with over the last several years in the industry.

With all its successes, the program has really begun to outgrow its original structure. In the early years, the SBA regulation and annual appropriations provided a kind of continuity for the program. The steady source of funds and operating framework helped us to get through those early startup years.

Unfortunately, we have come to the point now where those very features, in fact, restrict the growth of the industry. And particularly, the annual appropriations are no longer a reliable source.

And just to point that out, let me cite what has happened over the last 5 years. In 1 year, we were eliminated from the budget in an oversight by the Senate Budget Committee. In another year, we were frozen at a constant level. Another year, our funds were decreased. And in the last 2, we have effectively been threatened with elimination by the proposal to eliminate the credit programs and transfer substantial SBA operations to Commerce.

I submit that the kind of uncertainty that these events have created makes it very difficult for us to run any kind of reliable business. So I think the overriding reason for COSBI is to provide a level of stability in which we can continue some of the successes that I cited earlier, and reduce some of the uncertainty that has been provided as a result of some of these issues that I have just cited.

The other important factor is to continue to attract private capital to the program. I think during this period of uncertainty, it is quite difficult to get individuals and corporations to put up their money to invest in MESBIC's not knowing what is going to happen. I have had occasion to talk to a couple of MESBIC executives, both

of small and large companies, and corporate and individually sponsored. And they all say that they are prepared to invest additional capital. But in this environment of uncertainty, it just does not make good business sense to put your capital in, not knowing what the rules of the game are going to be and not knowing whether or not leverage is going to be available in the future.

So I think to some extent, while there have continued to be some new MESBIC's licensed, this period of uncertainty has put a damper on investment of additional capital in existing MESBIC's.

In addition to the uncertainties surrounding funding, we have been faced with an erratic administration of the regulations as well. As you may recall, in the administration of Mr. Cardenas, the SBA put a complete moratorium on the licensing of MESBIC's for a period of time. Shortly following that, there was a revision of the regulations, a substantial revision of the regulations regarding MESBIC's and SBIC's. And while that was not all bad—there were certainly some positive things to come out of that legislation or that revision of the regulations—rather, there was a considerable period of uncertainty, again in which it made it very difficult to operate.

Fortunately, Mr. Cardenas was replaced with the more enlightened leadership of Jim Sanders at the SBA. And we did have a period where we were back on track and continued to grow, but again, operating under those uncertainties that I cited earlier.

As you are aware, Mr. Sanders left the SBA in March of this year and, although he has not been officially replaced, the new acting administrator has proposed that the MESBIC Program be eliminated and that, as I cited earlier, many of the SBA programs be transferred to Commerce, not to mention some of the other actions that he has taken, which I am sure you are all familiar with. So I will not go into that.

So to summarize why we need COSBI, we simply cannot continue to operate in the kind of environment that we have been operating in and thrive. So it is essential that we do produce a new environment. I think COSBI does that.

The legislation that we are presenting is the culmination of extensive work on the part of the MESBIC's, the SBIC's, public policy makers and Wall Street analysts. This has been in development for a considerable period of time. There has been a tremendous cooperative effort to produce this. We think we have got a lot of bugs out of it. And I want to go on record as personally thanking several members of the committee staff for the yeoman effort that they have contributed and helped us getting the legislation to the point where it is today. I would particularly mention Mr. Powers and Major Clark and Christine Russell, who have all been very supportive in helping us to get this to the point where it is now.

And I think we all agree that it is an effective piece of legislation and will move us considerably forward in fostering the kind of small business development and job creation that we think we can produce in the right kind of environment.

I might just summarize briefly. One very important point that I might mention as well, in addition to reducing the level of uncertainty is this issue of the budget savings. The legislation has been written in such a way that the $500 million Treasury backstop is

subject to appropriation. The backstop is thus treated as an authorization and not as an appropriation and would not be scored as budget authority or outlays.

So, as you are aware, Mr. Chairman, the House Budget Committee Chairman Gray confirmed this fact in a letter to you several weeks ago. So we think this is a very important feature of the bill, the fact that it does provide these budget savings.

And I think, in addition, discussions with Wall Street analysts have indicated that the treatment of the backstop in this fashion would not really affect the marketability and attractiveness of COSBI features. So I know there was some concern in our last testimony about this issue, and I think this has been a way to resolve that concern.

The cash purchase of the FFB portfolio would also have a positive effect on the budget. The exact amount of the savings is as yet to be scored, but a worst case scenario puts it at several hundred million dollars. So in any event, however this is achieved, we think that it will be a significant savings. And the establishment of COSBI and the creation of the MESBIC Trust will effectively eliminate the $40 million appropriation that is provided to MESBIC's on a yearly basis. So that represents an additional savings going forward in terms of the budget process.

Given your concerns about time, Mr. Chairman, I might skip through some of the information on the COSBI operational structure and perhaps let Mr. Noojin discuss some of that, and move more expeditiously to the trust feature, which I know the committee is particularly interested in.

So, Tom, I will leave it to you to talk more about the management and the funding and the regulatory aspects of COSBI and move specifically to the trust.

Mr. MITCHELL. Thank you very much.

Mr. Noojin, are you all set?

Mr. HILL. Well, I am going to——

Mr. MITCHELL. Oh, you are going to wrap-up?

Mr. HILL [continuing]. Wrap up with—I am going to talk about the trust and leave those issues to him.

Mr. MITCHELL. All right.

Mr. HILL. We have given you a set of charts that outline the trust and the computer model that has been used to generate it. And I will talk more specifically about that in just a moment.

Unlike regular SBIC's, MESBIC's, of course, specialize in investing in minority-owned small businesses. In recognition of the additional risk that comes with investing in a restricted group of small businesses, the MESBIC's over the years have received incentives beyond those offered to regular SBIC's.

MESBIC's obtain funds through SBA preferred stock purchased by the SBA and through debentures that are issued with a 3-percent subsidy for the first 5 years of a 10-year debenture, so that, for example, on a 12-percent, 10-year debenture, MESBIC's would pay 9 percent on that debenture for the first 5 years.

These provisions have allowed MESBIC's to continue to serve the important public policy goals of promoting minority entrepreneurship, management training, and employment. And by combining public with private funds these public policy goals are achieved at

what we think are minimal cost to the Government with efficiency and effectiveness. In fact, a recent study shows that every dollar the Government invests in the MESBIC Program results in over $12 in tax revenues and other benefits. So I think that justifies the comment about efficiency and effectiveness.

COSBI would continue to serve these goals by setting up a trust within the corporation to continue to encourage investments in the minority small business community. The trust would be established by transferring the existing MESBIC portfolio from the SBA to COSBI for a period of 50 years. The trust would also receive $100 million from the proceeds of the sale of the Federal Financing Bank assets to COSBI. And the cash generated from the trust then would be used to continue to provide this interest rate subsidy on the MESBIC debentures and to provide for the purchase of MESBIC preferred stock. So the debenture subsidy and the purchase of preferred stock would remain in place.

MESBIC's, like other SBIC's, would also be allowed to go to the COSBI window for debentures and would have to meet the credit criteria set forth by the corporation. The difference would be that for the debentures issued to MESBIC's, the trust would provide an interest rate subsidy for the first 5 years.

Another important feature which I will talk about in more detail when I move to the charts is the loss reserve funding for MESBIC debentures.

The trust is also used for two important other purposes. Specifically, the funds would be used to cover the operating costs of administering the trust and, as I cited, to cover any losses realized on MESBIC preferred securities or debentures. This feature is important because it will ensure that COSBI will continue to have access to the market at a competitive rate because it substantially reduces any risk associated with the MESBIC portfolio debentures and preferred stock.

Administration of the trust will be performed by five trustees. The selection process for the trustees has been developed to ensure that the interests of the MESBIC's, the corporation, and the public are all represented. Three of the trustees will be nominated by MESBIC's and appointed by COSBI's board of directors. At least three of the trustees would at all times be persons from MESBIC's. This requirement guarantees that the majority of the trustees will have experience in the industry and will administer the trust in the best interests of the MESBIC's.

The nomination of trustees by MESBIC's will be by cumulative vote, based on the number of shares of voting common stock of the corporation held by each MESBIC. Each of the trustees nominated by the MESBIC's will be appointed as trustees by the corporation's board of directors unless, for good cause shown, the board refuses to approve a nominee, in which event a new nominee would be nominated by the MESBIC industry.

The appointed nominees will serve 3-year terms, with each serving no more than two consecutive terms.

In addition to the MESBIC industry nominees, there will be two other trustees, one appointed by the President to serve at the President's pleasure, and this person will of course represent the public interest in the administration of the trust; and a second

trustee who will be ex officio the chairman of the board of directors of the corporation, or his designee. So, as I indicated, both the MESBIC interest, the public and the corporation will be represented in the trust administration.

Now, at this point I might move to the charts. As I indicated, Herb Wilkins, who is chairman of our legislative committee and one of the chief architects of the trust, has generated a computer model for a 50-year period which shows that the trust could continue to operate and provide the debenture subsidy and some level of preferred stock to the MESBIC industry.

And with that I might move to the charts to talk about it.

This first chart here is a breakdown of the MESBIC portfolio currently held by the SBA. This shows the maturity of the portfolio for the next 15 years, I think it is.

This next column is the amount of debentures maturing each year. This simply represents the percent of the entire portfolio which debentures at this point totals $100 million.

Reserve for losses for nonoperating MESBIC's, those which are currently not operating, has been eliminated from the amount maturing to give a total that would actually go into the trust on an annual basis.

If we add in addition to the maturing debentures each year the interest earned at 12 percent on these debentures, take interest that would not be earned from nonoperating companies, reduced by the debentures subsidies that would continue to be paid on these debentures, adding back the dividends that are currently being paid on the preferred stock, the final column indicates the income from the existing portfolio that would accrue to the trust each year, starting with $13 million in the first year, holding fairly steady at that level, increasing to $16 million in 1990, and declining thereafter as the portfolio of debentures starts to wind down.

Mr. MITCHELL. Excuse me. I did not follow you.

Mr. HILL. OK, let me try again.

Mr. MITCHELL. The way I read this, your high mark comes in 1993, right?

Mr. HILL. I am sorry. You are correct, Mr. Chairman, it is 1993. You are right. It increases to $18 million in 1993 and 1994, which are the peak years. There is a peak of maturities in 1993—1992, 1993, 1994, and from that point it does decline. I stand corrected.

OK, I think we can move to the second chart. So that, that is an indication of the level of income that will be generated by the trust each year.

[Chart.]

Mr. HILL. Here we have an analysis of the inflow and outflow of funds into the trust for a 10-year period. The charts that you or the model that you have carries this analysis through to the entire 50-year period. For the purpose of the hearing and the demonstration here we have chosen to show a 10-year period here on the charts.

And at the top you see the initial balance. And this is derived from the $100 million sale of the FFB portfolio. The sale of the FFB portfolio, $100 million of that would be injected into the trust. There is an additional $34 million which I will talk about in a few minutes.

The second line then shows the funds from the portfolio from chart 1 that we talked about, coming into the trust. In the first year we estimate that to be some $13 million.

In addition to that, there is the interest earnings on the $134 million and the additional funds that are in the trust, giving a total of $159 million into the trust in the first year. So that is the inflow into the trust.

Subtracted from that out-flows, we have estimated in the first year intending to issue some $20 million in preferred debentures. You will note that that—not preferred debentures but preferred stock—that declines over the life of the trust, but it declines at a rate of about 4 percent. So for a considerable period of time we would continue to provide a level of preferred stock for the industry.

The second line under disbursements shows the debentures subsidy. The debentures issued would not be issued out of the trust but would of course be issued through COSBI. But the trust would continue to provide for the subsidy on the debentures. And this next line shows the debenture subsidy for each of those 10 years. Obviously, it increases with the level of increase in the debentures that are issued through COSBI.

There is an administration fee to administer the trust. We think the number we have shown here is fairly conservative in that we do not think it is going to cost that much. But in the interest of conservatism and making sure this is a model that could be achieved, we have used a fairly large number in terms of the administrative cost of the trust.

And lastly, this is the funded loss reserve that I talked about, so that 9 percent of the debentures that are issued in any year will actually be set aside from the trust to provide a loss reserve for any losses, any potential losses on debentures that are issued to MESBIC's. And Herb Wilkins assures me that this feature makes the MESBIC paper in COSBI as safe as any there is around, because if you look back in later years, with about 285 million debentures outstanding you have got actual cash of $25 million that could fund losses on debentures in the trust. There are not very many portfolios around that have that kind of funded loss reserve to sustain any potential losses on the debenture portfolios.

The next line simply shows the remaining balance in the trust as a result of the cash inflows and the cash outflows. And, of course, this grows over the period of time.

The next two lines essentially show the amount of debentures being issued each year to the MESBIC's. The level of debentures are increasing at a rate of about 8 percent a year which results in about a 2- to 3-percent increase in the total leverage available to the MESBIC's each year. So that the amount of debentures being issued is increasing and the amount of preferred is declining slightly. But the amount of total leverage being made available to MESBIC's is in fact increasing over a period of time.

Now, I indicated that I would talk about the initial balance that we talked about. There is an additional $34 million we show coming in the first year. Based on our original structure of the trust, we were concerned about the ability of the trust to sustain itself for a considerable period of time. As a result of that we have

added an additional feature that we think assures the viability of the trust for a much longer period of time. That is a repurchase by MESBIC's of the existing preferred stock outstanding at a discount.

For the purposes of this demonstration or of this explanation we have used a purchase at 40 percent of the face value. That is not a fixed number. It might be 50 percent, it might be 60 percent. But for the purposes of this demonstration we have used 40 percent; $173 million in MESBIC preferred stock is currently outstanding. And in the first year we have assumed overall that of this $173 million outstanding, 70 percent of that would be bought back during the first 3 years.

In the first year we have shown that 50 percent of that would be bought back, which results in the $34 million that I talked about. In the second year 10 percent, which is an additional $7 million. And another 10 percent in the third year. So that would effectively add a considerable amount to the trust. And we think that this is an important feature that really ensures the viability of the trust over an extended period of time.

As is indicated, this is the first 10-year analysis of the trust. At the end of year 10 we see that the balance of the trust has gone from $135 to $186 million. If you look at the 50-year computer model, that balance will have increased to $1.7 billion over a 50-year period, with $444 million in cash, $176 million in preferred stock receivable, and $1 billion in the funded loss reserve, and $16 million in preferred dividends receivable.

The trust would carry a liability of about $855,000, which of course could be paid out of the cash proceeds of the balances maintained at the trust.

So at the end of the 50-year period, assuming the model behaves like we have indicated here—and of course, we all know that they do not behave like we forecast—but it does indicate that there would be a substantial corpus to be contributed to the Government from the trust.

So we think this represents a relatively small Government outlay to achieve significant results that fully contribute to our public policy goals.

The one-time appropriation of $100 million represents about 2½ years of MESBIC appropriation at the current $40 million level. So beyond that $40 million level—or beyond that $100 million there would not be any need for additional appropriations from the Government. We think that represents a significant saving. And as I said earlier, certainly eliminates the need to come to Congress every year for that additional appropriation.

I have already talked about the loss reserve feature of the trust which we think makes it particularly attractive.

During this period of uncertainty, the possible loss of some venture capital flowing in as a result of the proposed tax bill, we think this provides some stability and some level of certainty about the availability of funding for the kind of businesses that we finance.

In summary, we think the COSBI regulation and funding of the MESBIC industry will offer many benefits—continued existing benefits as well as offering many new additional benefits. The combined shareholder-elected/presidentially appointed board will offer venture capital experience and public interest representation. The

stability of funds is expected to be improved by removing the industry from its reliance on the annual appropriations. And we will continue to be monitored through what we think is an appropriate licensing process through COSBI.

At this point, Mr. Chairman, I might respond to any questions that any of the members have regarding the trust.

[Mr. Hill's prepared statement, with attachments, follows:]

PREPARED STATEMENT OF DUANE E. HILL, CHAIRMAN, AMERICAN ASSOCIATION OF MESBIC's

GOOD MORNING MR. CHAIRMAN AND MEMBERS OF THE HOUSE SMALL BUSINESS COMMITTEE. MY NAME IS DUANE HILL AND I'M PRESIDENT OF EQUICO CAPITAL CORPORATION IN NEW YORK AND CHAIRMAN OF THE AMERICAN ASSOCIATION OF MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANIES (AAMESBIC).

IT IS MY PLEASURE TO BE HERE TODAY TO TESTIFY IN SUPPORT OF HR 5019, A BILL TO CREATE THE CORPORATION FOR SMALL BUSINESS INVESTMENT (COSBI). I AM ALSO PLEASED TO NOTE THAT THE BILL ENJOYED THE ORIGINAL COSPONSORSHIP OF 38 MEMBERS OF THIS COMMITTEE. I THINK THIS IS A GOOD INDICATION THAT MANY OF YOU BELIEVE, AS WE DO, THAT COSBI IS AN INNOVATIVE, FINANCIALLY SOUND WAY OF PROVIDING FOR THE CONTINUING OPERATIONS OF MESBICS AND SBICS.

AS PRESIDENT OF EQUICO, I DIRECT THE ACTIVITIES OF ONE OF THE LARGEST INVESTMENT COMPANIES IN THE MESBIC INDUSTRY. EQUICO CAPITAL CORPORATION IS A SUBSIDIARY OF THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES. SINCE ITS ESTABLISHMENT IN 1971, EQUICO HAS MADE INVESTMENTS IN A BROAD RANGE OF INDUSTRIES INCLUDING MANUFACTURING, DISTRIBUTION, RETAIL, SERVICE AND COMMUNICATIONS COMPANIES THROUGHOUT THE COUNTRY. WITH A PRIVATE CAPITAL BASE OF OVER $10 MILLION, WE NOT ONLY MAKE DIRECT INVESTMENTS IN

MINORITY-OWNED SMALL BUSINESSES, BUT WE ALSO FORM SYNDICATIONS FOR LARGER INVESTMENTS AND ENABLE OUR CLIENTS TO SUPPORT FURTHER BORROWING FROM SENIOR LENDERS.

EQUICO HAS BEEN IN EXISTENCE ALMOST SINCE THE BEGINNING OF THE MESBIC PROGRAM. THE EQUITABLE, ALONG WITH SEVERAL OTHER LARGE U.S. PRIVATE INSTITUTIONS, RESPONDED TO A CALL FROM THE NIXON ADMINISTRATION TO PROVIDE FUNDS FOR INVESTMENT IN MINORITY OWNED SMALL BUSINESSES. IN TURN, THE GOVERNMENT PROVIDED MATCHING FUNDS FOR INVESTMENT, USING THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM AS A MODEL. THUS WAS BORN A PARTNERSHIP BETWEEN PRIVATE SECTOR INVESTORS AND THE FEDERAL GOVERNMENT THAT RESULTED IN THE TREMENDOUS GROWTH IN THE SIZE AND EXPERTISE OF THE MINORITY SMALL BUSINESS COMMUNITY. WHEN EQUICO WAS ESTABLISHED IN 1971, THE AVERAGE MESBIC INVESTMENT WAS LESS THAN $13,000, AND THE INDUSTRY'S TOTAL INVESTMENTS AMOUNTED TO ONLY $2.2 MILLION. BY 1985, MESBICS HAD REACHED AN ANNUAL INVESTMENT FIGURE OF $107.7 MILLION, WITH THE MAJORITY OF OUR INVESTMENTS AT OVER $100,000.

THE MESBIC PROGRAM IS A LEADER IN MINORITY SMALL BUSINESS DEVELOPMENT.

CONTRARY TO ADMINISTRATION CLAIMS, THERE ARE NOT OTHER SIMILAR SOURCES OF VENTURE CAPITAL AVAILABLE TO THE COMMUNITY WE SERVE. OUR INDUSTRY OFFERS A CADRE OF SKILLED, EXPERIENCED, AND ETHNICALLY DIVERSE INVESTORS WHO UNDERSTAND THE SPECIAL NEEDS OF MINORITY ENTREPRENEURS AND ARE WELL-EQUIPPED TO SERVE THOSE NEEDS. THE PRIVATE/PUBLIC PARTNERSHIP NATURE OF OUR INDUSTRY INSURES THAT OUR INVESTORS' TIME AND MONEY ARE WISELY SPENT. BY PLACING OUR PRIVATE CAPITAL AT RISK FIRST, OUR PROGRAM WAS DEVELOPED IN A WAY TO INSURE THAT OUR INVESTMENTS WOULD BE MADE IN THOSE COMPANIES EXHIBITING THE GREATEST POTENTIAL FOR SUCCESS.

EXAMPLES OF OUR SUCCESS STORIES INCLUDE ESSENCE MAGAZINE, WITH A CIRCULATION OF 800,000 AND ADVERTISING REVENUES OF $11 MILLION. TEN MESBICS INVESTED IN CONNECTION COMMUNICATION CORPORATION IN NEWARK, A CABLE TV FRANCHISE WHICH HAS OVER 25,000 CUSTOMERS. THIS INVESTMENT HAS CREATED SUBSTANTIAL VALUE FOR THE ENTREPRENEURS AND THE MESBIC COMMUNITY. XINIX, INC., A SANTA CLARA SEMICONDUCTOR INSTRUMENTATION COMPANY, HAS ALSO RECEIVED MESBIC FINANCING. THE CHINESE-AMERICAN COMPANY HAS DOUBLED ITS SALES EACH YEAR FOR THE PAST THREE YEARS, AND RECENTLY RECEIVED ORDERS FROM IBM.

AMONG OUR HISPANIC DEALS WE LIST NINFAS, INC., A CHAIN OF MEXICAN RESTAURANTS WHICH RANKED 70TH ON THE 1985 HISPANIC BUSINESS 500. WE ALSO INVESTED IN DIGITRON TOOL CO., A TOOL AND DIE MACHINING COMPANY WHICH RANKED 85TH ON THE HISPANIC BUSINESS 500. DIGITRON, WHICH WAS STARTED BY TWO CUBAN REFUGEES IN 1977, NOW EMPLOYS 250 PEOPLE AND HAD 1984 SALES OF $15.5 MILLION.

THE POINT OF MY GOING THROUGH THESE EXAMPLES IS TO DEMONSTRATE THE DIVERSITY OF OUR INDUSTRY ACROSS RACES, ACROSS INDUSTRIES, AND ACROSS THE COUNTRY. NO OTHER SOURCE OF MINORITY VENTURE CAPITAL CAN CLAIM THE BREADTH OF EXPERIENCE POSSESSED BY MESBICs. AND OUR EXPERIENCE PRODUCES RESULTS. BETWEEN 1978 AND 1985, WE INVESTED OVER $462 MILLION IN 5,422 MINORITY OWNED SMALL BUSINESSES. THESE SAME COMPANIES PRODUCED OVER $4.5 BILLION IN REVENUES AND CREATED OVER 82,000 JOBS. LAST YEAR ALONE, OUR INVESTMENTS RESULTED IN THE CREATION OF OVER $105 MILLION IN TAX REVENUE.

SO IF THE INDUSTRY IS DOING SO WELL AND ACCOMPLISHING SO MUCH, WHY DO WE NEED TO MOVE INTO THE CORPORATION FOR SMALL BUSINESS INVESTMENT? THERE IS ONE SIMPLE ANSWER TO THAT QUESTION - STABILITY. IT IS ABSOLUTELY ESSENTIAL

THAT, AS LONG TERM VENTURE CAPITAL INVESTORS, WE HAVE A STABLE FUNDING SOURCE AND STABLE RULES BY WHICH WE MAKE OUR INVESTMENTS.

WITH ALL ITS SUCCESS, THE MESBIC PROGRAM HAS BEGUN TO OUTGROW ITS ORIGINAL STRUCTURE. IN THE EARLY YEARS, SMALL BUSINESS ADMINISTRATION (SBA) REGULATION AND ANNUAL APPROPRIATIONS LENT A SENSE OF CONTINUITY TO THE PROGRAM. THE STEADY SOURCE OF FUNDS AND OPERATING FRAMEWORK HELPED US TO GET THROUGH THE START-UP YEARS OF OPERATIONS. UNFORTUNATELY, THESE TWO FACTORS NOW CONSTRICT US FROM FURTHER GROWTH.

ANNUAL SBA APPROPRIATIONS ARE NO LONGER A RELIABLE FUNDING SOURCE. IN THE PAST FIVE YEARS, WE HAVE BEEN TEMPORARILY ELIMINATED FROM THE BUDGET AS AN "OVERSIGHT" BY THE SENATE BUDGET COMMITTEE, WE HAVE BEEN FROZEN AT A CONSTANT LEVEL, OUR FUNDS HAVE BEEN DECREASED, AND WE HAVE BEEN THREATENED TWICE WITH ELIMINATION AS PART OF THE SBA'S CREDIT PROGRAMS.

THE RESULTING UNCERTAINTY IN TERMS OF FUTURE FUNDING LEAVES OUR INVESTORS IN A VERY DIFFICULT SITUATION. SEVERAL HUNDRED MILLION DOLLARS OF PRIVATE CAPITAL FROM CORPORATIONS, INDIVIDUALS, COMMUNITIES, AND OTHER SOURCES HAVE BEEN INVESTED IN THEIR COMPANIES. IF THEY WANT TO INSURE THE

AVAILABILITY OF FUNDS FOR FUTURE INVESTMENTS, THEY ARE COMPELLED TO ATTEMPT TO RAISE ADDITIONAL PRIVATE CAPITAL. ON THE OTHER HAND, THOSE PRIVATE CAPITAL SOURCES ARE LESS WILLING TO PROVIDE MORE FUNDS IF THE MESBIC CAN'T ASSURE THEM THAT THEIR FUNDS WILL BE MATCHED WITH GOVERNMENT LEVERAGE IN THE FUTURE. GIVEN THIS SITUATION, MESBIC EXECUTIVES CAN MAKE ONE OF TWO CHOICES: THEY CAN CONTINUE TO SEEK OUT NEW COMPANIES IN WHICH TO INVEST AND PRAY THAT ADDITIONAL FUNDS WILL BE AVAILABLE IN THE FUTURE, OR THEY CAN HOLD ON TO THEIR MONEY TO FINANCE THEIR EXISTING PORTFOLIO'S FUTURE NEEDS. OUR INVESTMENT RECORD SHOWS WE'VE CHOSEN TO KEEP UP OUR INVESTMENTS AND OUR PRAYERS. BUT WE CAN NOT CONTINUE TO RELY ON GOOD FORTUNE TO SEE US THROUGH.

AS IF FUNDING INSTABILITY WERE NOT ENOUGH, WE ARE ALSO FACED WITH AN EXTREMELY ERRATIC ADMINISTRATION OF THE REGULATIONS. IN 1981, MICHAEL CARDENAS WAS THE ADMINISTRATOR OF THE SBA. DURING HIS SHORT TENURE, HE PLACED A COMPLETE MORATORIUM ON NEW MESBIC LICENSING FOR SEVERAL MONTHS SIMPLY FOR THE PURPOSE OF TAKING THE TIME TO LEARN MORE ABOUT THE INDUSTRY BEFORE PROMOTING ITS FURTHER GROWTH. THE FOLLOWING YEAR, IN 1982, THE SBA WAS PROPOSING A COMPLETE OVERHAUL OF SBIC REGULATIONS THAT EVENTUALLY

RESULTED IN THE ADOPTION OF REVISION 6 IN 1983.

LUCKILY, CARDENAS WAS REPLACED WITH JIM SANDERS, A MAN WHO RECOGNIZED THE VALUE OF THE PROGRAMS ADMINISTERED BY HIS AGENCY. UNDER SANDERS THE MESBIC PROGRAM WAS BACK ON TRACK AND GROWING AGAIN. AS YOU ARE ALL AWARE, HOWEVER JIM SANDERS LEFT THE SBA ON MARCH 1 OF THIS YEAR. HE HAS BEEN REPLACED BY A MAN WHO WANTS TO DISMANTLE THE SBA AND COMPLETELY ELIMINATE THE MESBIC PROGRAM IN THE PROCESS.

WE CANNOT CONTINUE TO OPERATE IN THIS ATMOSPHERE OF FINANCIAL AND ADMINISTRATIVE UNCERTAINTY. COSBI WOULD REMOVE MESBICS FROM THIS ENVIRONMENT AND PROVIDE THEM WITH A MORE RELIABLE FUNDING SOURCE AND REGULATORS WHO UNDERSTAND THE OPERATIONAL REQUIREMENTS IN MAKING LONG TERM INVESTMENTS.

THE CORPORATION FOR SMALL BUSINESS INVESTMENT REPRESENTS THE CULMINATION OF EXTENSIVE WORK ON THE PART OF THE MESBIC AND SBIC INDUSTRIES, PUBLIC POLICY MAKERS, AND WALL STREET ANALYSTS. ALL OF THE PARTIES WORKED TOGETHER TO DEVELOP A BILL TO ESTABLISH COSBI. THEY ENVISIONED THE CORPORATION AS THE MOST EFFECTIVE APPROACH TO COMBINE GOVERNMENT EFFORTS

TO FOSTER SMALL BUSINESS DEVELOPMENT AND ITS RESULTING JOB CREATION AND INNOVATION WITH THE INCREASED STABILITY AND ACCESS TO PRIVATE CAPITAL AN INSTITUTION SUCH AS COSBI WOULD PROVIDE.

WE BELIEVE THAT THE COSBI LEGISLATION, AS WRITTEN, WILL RESULT IN A SIGNIFICANT BUDGET SAVINGS. THIS SAVINGS WILL OCCUR FOR SEVERAL REASONS. MY COLLEAGUE MR. NOOJIN WILL DISCUSS THESE AREAS IN MORE DETAIL, BUT I WOULD LIKE TO BRIEFLY MENTION A FEW OF THEM.

FIRST, AND MOST SIGNIFICANTLY, THE COSBI LEGISLATION HAS BEEN WRITTEN IN SUCH A WAY THAT THE $500 MILLION TREASURY BACKSTOP IS SUBJECT TO APPROPRIATION. THE BACKSTOP IS THUS TREATED AS AN AUTHORIZATION, NOT AN APPROPRIATION, AND WOULD NOT BE SCORED AS BUDGET AUTHORITY OR OUTLAYS. AS YOU ARE AWARE, MR. CHAIRMAN, HOUSE BUDGET COMMITTEE CHAIRMAN GRAY ALREADY CONFIRMED THIS FACT OVER A MONTH AGO BY LETTER. DISCUSSIONS WITH WALL STREET ANALYSTS INDICATE THAT THIS TREATMENT OF THE BACKSTOP SHOULD NOT AFFECT THE MARKET ATTRACTIVENESS OF COSBI'S SECURITIES.

SECOND, THE CASH PURCHASE OF THE FFB PORTFOLIO WILL HAVE A POSITIVE EFFECT ON THE BUDGET. ALTHOUGH THE EXACT AMOUNT OF SAVINGS THAT WILL BE

SCORED AS A RESULT OF THIS SALE OF ASSETS HAS NOT YET BEEN DETERMINED, EVEN A WORST CASE SCENARIO PUTS IT AT SEVERAL HUNDRED MILLION DOLLARS.

FINALLY, THE ESTABLISHMENT OF COSBI WOULD TAKE MESBICS OUT OF THE ANNUAL APPROPRIATIONS PROCESS, SAVING APPROXIMATELY $40 MILLION A YEAR AT THE PRESENT FUNDING LEVEL.

## COSBI'S OPERATIONAL STRUCTURE

THERE ARE FOUR MAJOR AREAS IN WHICH THE SBA PRESENTLY REGULATES THE MESBIC AND SBIC INDUSTRIES: MANAGEMENT, FUNDING, LICENSING, AND MONITORING. COSBI WILL REPLACE SBA REGULATION OF THESE AREAS IN WHAT WE BELIEVE WILL BE AN EFFICIENT AND EFFECTIVE MANNER.

### MANAGEMENT

UNDER THE COSBI PROPOSAL, IMMEDIATELY AFTER IT IS ESTABLISHED, COSBI WILL BE MANAGED BY AN INTERIM BOARD OF DIRECTORS APPOINTED BY THE PRESIDENT. THE BOARD WILL CONSIST OF TWO REPRESENTATIVES OF THE SBIC INDUSTRY, TWO SMALL BUSINESS REPRESENTATIVES, AND THE SBA ADMINISTRATOR. THIS BOARD WILL BE RESPONSIBLE FOR ARRANGING COSBI'S INITIAL $20 MILLION STOCK OFFERING, WHICH WILL BE RAISED FROM THE MESBIC AND SBIC LICENSEES.

ONCE THE $20 MILLION STOCK OFFERING IS COMPLETED, A PERMANENT BOARD WILL REPLACE THE INTERIM BOARD. THE PERMANENT BOARD WILL CONSIST OF 15 MEMBERS. TEN OF THESE MEMBERS WILL BE ELECTED BY STOCKHOLDERS THROUGH CUMULATIVE VOTING RIGHTS. THE OTHER FIVE MEMBERS WILL BE APPOINTED BY THE PRESIDENT, WITH AT LEAST ONE COMING FROM THE MESBIC INDUSTRY.

THE TEN ELECTED BOARD MEMBERS ARE EXPECTED TO COME FROM AMONG THE LEADERSHIP OF THE MESBIC AND SBIC INDUSTRIES. AS SUCH, THEY WOULD BRING TO THEIR POSITIONS YEARS OF EXPERIENCE IN THE VENTURE CAPITAL INDUSTRY. THIS EXPERIENCE WILL HELP THEM IN THEIR ROLES AS POLICY MAKERS FOR COSBI. THE FIVE POLITICALLY-APPOINTED BOARD MEMBERS WILL ENSURE THAT THE BOARD CONTINUES TO SET AS HIGH PRIORITIES THE PUBLIC POLICY GOALS FOR WHICH THE CORPORATION IS BEING ESTABLISHED. IN A SENSE, THE MAKE-UP OF THE BOARD WILL SERVE TO CREATE A SYSTEM OF CHECKS AND BALANCES WHICH WILL RESULT IN THE PURSUANCE OF THESE GOALS IN THE MOST EFFICIENT MANNER POSSIBLE.

IN ADDITION, COSBI WILL HAVE THE RESPONSIBILITY OF SUBMITTING AN ANNUAL REPORT AND AUDIT TO THE TREASURY, THE PRESIDENT, THE SBA, AND THE HOUSE AND SENATE SMALL BUSINESS COMMITTEES.

**FUNDING**

As a source of funds, COSBI would pool securities issued by MESBICs and SBICs and issue its own securities on the market. Its government sponsorship would allow COSBI to borrow at favorable rates, similar to other federally sponsored agencies such as the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). Under COSBI, MESBICs and SBICs admittedly would have to pay higher rates for their funds. We believe, however, that there are many other factors that would compensate for this increased cost of money. Chief among these factors is the increased funding stability we would achieve through COSBI. We believe we will have more control over our access to funds when it is based on our long term success as investors, rather than on the annual appropriations process.

The MESBIC and SBIC industries would be responsible for providing the initial capitalization of the Corporation. All operating companies would invest 2% of their private capital in the Corporation's common stock -- producing a total initial capital pool of approximately $20 million. Our industries are willing to make this investment because we believe the

FUNDING STABILITY AND OTHER BENEFITS WE WILL RECEIVE FROM THE CORPORATION WILL BE WORTH IT IN THE LONG RUN.

AS I WILL DISCUSS IN MORE DETAIL LATER, A TRUST WILL BE ESTABLISHED WITHIN COSBI TO ADDRESS THE SPECIAL INVESTMENT NEEDS OF MESBICs. IN ESSENCE, FOR A PERIOD OF 50 YEARS THE TRUST WILL BE USED AS A "SELF-SUSTAINING" ASSET BASE TO PROVIDE THE FINANCIAL INCENTIVES FOR THE MESBIC PROGRAM. CONVERSELY, IF THESE ASSETS DO NOT PRODUCE SUFFICIENT INCOME, THE RATE DIFFERENTIAL ON DEBENTURES AND THE OPTION OF ISSUING PREFERRED STOCK WOULD NO LONGER BE AVAILABLE TO MESBICs. THE CONTINUED EXISTENCE OF THE TRUST THEREFORE RELIES ON OUR SUCCESS AS SMALL BUSINESS INVESTORS.

AT THE END OF THE FIFTY YEAR PERIOD, THE LIQUIDATING TRUST WILL TERMINATE AND ANY OUTSTANDING PREFERRED STOCK AND DIVIDENDS, ALONG WITH THE REMAINING CORPUS OF THE TRUST, WILL BE TRANSFERRED TO THE U.S. TREASURY. AFTER THAT DATE, THE FINANCIAL INCENTIVES FOR MESBICs WILL TERMINATE. IN THE 50 YEAR INTERIM, COSBI WILL ESTABLISH SEPARATE ACCOUNTING FOR THE TRUST OPERATIONS TO THE SECRETARY OF THE TREASURY.

## LICENSING

THERE ARE SEVERAL REQUIREMENTS FOR OBTAINING A LICENSE TO OPERATE AS A SMALL BUSINESS INVESTMENT COMPANY. CHIEF AMONG THESE ARE THE CAPITALIZATION LEVEL (AT LEAST $1 MILLION), THE REQUIREMENT OF A STATE CHARTER, AND SPECIFIC STANDARDS ON MANAGEMENT EXPERTISE. THIS RESTRICTION OF ENTRY INTO THE INDUSTRY WAS DESIGNED TO PROTECT THE GOVERNMENT DOLLARS THAT GO INTO THE PROGRAM.

COSBI IS DESIGNED TO PROVIDE SIMILAR PROTECTION OF INVESTMENTS IN THE CORPORATION. COSBI WOULD REPLACE SBA'S LICENSING SYSTEM WITH CONTRACTUAL AGREEMENTS BETWEEN THE CORPORATION AND SBICs. NEW MESBICs AND SBICs WOULD HAVE TO MEET CRITERIA SIMILAR TO THOSE PRESENTLY USED BY THE SBA. COSBI WILL HAVE THE AUTHORITY TO SUSPEND OR TERMINATE THE CONTRACTS OF SBICs FOUND TO BE IN BREACH OF THOSE CONTRACTS. THE CONTRACTUAL ARRANGEMENT IS ALSO EXPECTED TO BE MORE EXPEDIENT THAN THE PRESENT LICENSING PROCESS. THUS, COSBI LICENSING IS EXPECTED TO PROVIDE THE SAME ADVANTAGES OF THE PRESENT SYSTEM, WITH A SHORTER TIME REQUIREMENT.

## MONITORING AND AUDITING

THE SBA MONITORS THE MESBIC INDUSTRY THROUGH ITS REPORT FILING

REQUIREMENTS. MESBICs MUST SUBMIT YEAR-END AUDITED FINANCIAL STATEMENTS, ANNUAL PORTFOLIO INFORMATION FORMS, AND PORTFOLIO FINANCING FORMS AFTER EACH INVESTMENT TRANSACTION. ADDITIONALLY, THE SBA CONDUCTS ANNUAL AUDITS OF EACH MESBIC'S INVESTMENTS AND ACTIVITIES. THE PURPOSE OF THESE MONITORING ACTIVITIES IS TO ENSURE THAT ALL LICENSEES ARE OPERATING IN COOPERATION WITH THE SMALL BUSINESS INVESTMENT ACT AND THE RULES AND REGULATIONS PERTAINING TO THE ACT.

UNDER COSBI, LICENSEES WILL BE REQUIRED BY THEIR CONTRACTUAL AGREEMENTS WITH THE CORPORATION TO SUBMIT TO AUDITS BY COSBI TO ASSURE COMPLIANCE WITH ITS REQUIREMENTS. IN ADDITION, THE SBA REGULATION THAT AN INDEPENDENT EXTERNAL AUDIT BE CONDUCTED WILL NOT CHANGE.

I WOULD LIKE TO STRESS HERE THE DIFFERENCE BETWEEN THE REGULATORY ROLES OF COSBI AND THE SBA. THE SBA IS SPECIFICALLY AUTHORIZED TO REVIEW COSBI'S CRITERIA FOR THE QUALIFICATION OF SBICs AND RULES GOVERNING THE OPERATIONS OF SBICs. SBA'S AUTHORITY DOES NOT EXTEND, HOWEVER, TO COSBI'S INTERNAL OPERATIONS OR TO THE OPERATIONS OF INDIVIDUAL SBICs. THAT WILL BE THE RESPONSIBILITY OF THE CORPORATION. IN CARRYING OUT ITS GENERAL

OVERSIGHT DUTIES, THE SBA IS AUTHORIZED TO EXAMINE COSBI'S BOOKS AND RECORDS, TO OBTAIN ANY NECESSARY REPORTS FROM COSBI, AND TO REPORT THE FINDINGS OF ITS REVIEWS TO CONGRESS.

THE CORPORATION WILL ESTABLISH OPERATING STANDARDS BY WHICH ALL MESBICS AND SBICS MUST ABIDE. THESE STANDARDS, AS I MENTIONED BEFORE, WILL BE BASED ON PRESENT SBA REGULATIONS AND GENERALLY ACCEPTED OPERATING STANDARDS FOR SIMILAR INSTITUTIONS. THESE STANDARDS WILL BE SET FORTH IN CONTRACTUAL AGREEMENTS BETWEEN COSBI AND THE INDIVIDUAL INVESTMENT COMPANIES. IT IS BELIEVED THIS SYSTEM WILL PROVIDE MORE REGULATORY STABILITY BECAUSE ANY CHANGES WOULD REQUIRE APPROVAL BY THE BOARD OF COSBI, THE MAJORITY OF WHOM WILL HAVE BEEN VOTED IN BY THE INDUSTRY AS COSBI SHAREHOLDERS, AND WHO ARE EXPECTED TO BE COGNIZANT OF THE SPECIAL NEEDS OF LONG TERM INVESTORS. THUS, THE COSBI BOARD OF DIRECTORS WILL SERVE THE OVERSIGHT FUNCTION FOR THE "BUSINESS PURPOSES" OF THE CORPORATION.

THE REGULATORY STRUCTURE OF COSBI ALSO PROVIDES FOR OVERSIGHT OF THE "PUBLIC PURPOSES" OF THE CORPORATION. CONGRESS, THE PRESIDENT, SBA AND TREASURY WOULD EACH BE GIVEN SPECIFIC OVERSIGHT RESPONSIBILITIES IN THIS

AREA. THE PRESIDENT WOULD PRACTICE HIS OVERSIGHT RESPONSIBILITIES THROUGH HIS APPOINTMENT OF FIVE OF THE FIFTEEN COSBI BOARD MEMBERS. THE SBA, AS MENTIONED EARLIER, WOULD MONITOR THE GENERAL RULES AND REGULATIONS AND WOULD REQUIRE REPORTS ON COSBI'S ACTIVITIES. THE TREASURY WOULD HAVE THE RESPONSIBILITY OF APPROVING ALL COSBI OBLIGATIONS ISSUED, AND CONGRESS WOULD HAVE ONGOING LEGISLATIVE OVERSIGHT OF THE CORPORATION.

MESBIC FUNDING

AT THIS POINT, I WOULD LIKE TO GO INTO A LITTLE MORE DETAIL REGARDING MESBIC FUNDING. UNLIKE REGULAR SBICs, MESBICs SPECIALIZE IN INVESTING IN SMALL BUSINESSES OWNED BY SOCIALLY OR ECONOMICALLY DISADVANTAGED ENTREPRENEURS. IN RECOGNITION OF THE ADDITIONAL RISK THAT COMES WITH INVESTING IN A RESTRICTED GROUP OF SMALL BUSINESSES, MESBICs HAVE RECEIVED INCENTIVES BEYOND THOSE OFFERED TO REGULAR SBICs.

MESBICs MAY OBTAIN MATCHING GOVERNMENT FUNDS IN ONE OF TWO WAYS. THE FIRST SOURCE OF LEVERAGE IS THROUGH SBA PREFERRED STOCK PURCHASES FROM THE MESBICs. THE SECOND SOURCE IS SBA DEBENTURES ISSUED TO MESBICs WITH A 3% INTEREST RATE SUBSIDY ON THE FIRST FIVE YEARS OF A TEN YEAR DEBENTURE. FOR

EXAMPLE, ON A 12% 10 YEAR DEBENTURE, A MESBIC WOULD PAY 9% THE FIRST FIVE YEARS AND 12% THE SECOND FIVE YEARS.

THESE PROVISIONS HAVE ALLOWED MESBICS TO CONTINUE TO SERVE THE IMPORTANT PUBLIC POLICY GOALS OF PROMOTING MINORITY ENTREPRENEURSHIP, MANAGEMENT TRAINING, AND EMPLOYMENT. AND BY COMBINING PUBLIC WITH PRIVATE FUNDS THESE PUBLIC POLICY GOALS ARE ACHIEVED AT A MINIMAL COST TO THE GOVERNMENT WITH MAXIMUM EFFICIENCY AND EFFECTIVENESS. IN FACT, A RECENT STUDY SHOWED THAT FOR EVERY DOLLAR THE GOVERNMENT INVESTS IN THE MESBIC PROGRAM, IT RECEIVES OVER TWELVE DOLLARS IN TAX REVENUE AND OTHER BENEFITS.

COSBI WOULD CONTINUE TO SERVE THESE GOALS BY SETTING UP A TRUST WITHIN THE CORPORATION TO CONTINUE TO ENCOURAGE INVESTMENTS IN THE MINORITY SMALL BUSINESS COMMUNITY. THE TRUST WOULD BE ESTABLISHED BY TRANSFERING THE EXISTING MESBIC PORTFOLIO FROM THE SBA TO COSBI FOR A PERIOD OF 50 YEARS. THE TRUST WOULD ALSO RECEIVE $100 MILLION FROM THE PROCEEDS OF THE SALE OF THE FFB ASSETS TO COSBI. THE CASH GENERATED FROM THE TRUST WOULD BE USED TO CONTINUE TO PROVIDE AN INTEREST RATE SUBSIDY ON MESBIC DEBENTURES AND TO

PURCHASE PREFERRED STOCK IN MESBICs. MESBICs, LIKE OTHER SBICs, WOULD GO TO THE COSBI WINDOW FOR DEBENTURES, AND WOULD HAVE TO MEET THE CREDIT CRITERIA SET FORTH BY THE CORPORATION. THE DIFFERENCE WOULD BE THAT, FOR DEBENTURES ISSUED TO MESBICs, THE TRUST WOULD PROVIDE AN INTEREST RATE SUBSIDY FOR THE FIRST FIVE YEARS.

THE TRUST FUNDS WOULD ALSO BE USED FOR OTHER PURPOSES. SPECIFICALLY, THE FUNDS WOULD BE USED TO COVER THE OPERATING COSTS OF ADMINISTERING THE TRUST AND TO COVER ANY LOSSES REALIZED ON MESBIC PREFERRED SECURITIES OR DEBENTURES. THIS LATTER USE WILL INSURE THAT COSBI WILL RECEIVE A COMPETITIVE MARKET RATE ON ITS SECURITIES.

ADMINISTRATION OF THE TRUST WILL BE PERFORMED BY FIVE TRUSTEES. THE SELECTION PROCESS FOR THE TRUSTEES HAS BEEN CAREFULLY DEVELOPED TO INSURE THAT THE INTERESTS OF MESBICs, THE CORPORATION, AND THE PUBLIC ARE ALL WELL REPRESENTED. THREE OF THE TRUSTEES WILL BE NOMINATED BY MESBICs AND APPOINTED BY COSBI'S BOARD OF DIRECTORS. FURTHER, AT LEAST THREE OF THE TRUSTEES WILL, AT ALL TIMES, BE PERSONS FROM MESBICs. THIS REQUIREMENT GUARANTEES THAT THE MAJORITY OF THE TRUSTEES WILL HAVE EXPERIENCE IN THE

INDUSTRY AND WILL ADMINISTER THE TRUST WITH THE BEST INTERESTS OF MESBICs IN MIND.

THE NOMINATION OF TRUSTEES BY MESBICs WILL BE BY CUMMULATIVE VOTE, BASED ON THE NUMBER OF SHARES OF VOTING COMMON STOCK OF THE CORPORATION HELD BY EACH MESBIC. EACH OF THE TRUSTEES NOMINATED BY THE MESBICs WILL BE APPOINTED AS TRUSTEES BY THE CORPORATION'S BOARD OF DIRECTORS UNLESS, FOR GOOD CAUSE SHOWN, THE BOARD REFUSES TO APPROVE A NOMINEE, IN WHICH EVENT A NEW NOMINEE WILL BE NOMINATED BY THE MESBIC INDUSTRY. THE APPOINTED NOMINEES WILL SERVE THREE YEAR TERMS, WITH EACH SERVING NO MORE THAN TWO CONSECUTIVE TERMS.

IN ADDITION TO THE MESBIC INDUSTRY NOMINEES, THERE WILL BE TWO OTHER TRUSTEES. ONE OF THE TRUSTEES WILL BE APPOINTED BY THE PRESIDENT, TO SERVE AT THE PRESIDENT'S PLEASURE. THIS PERSON WILL REPRESENT THE PUBLIC INTEREST IN THE ADMINISTRATION OF THE TRUST. THE FINAL TRUSTEE WILL BE EX-OFFICIO, THE CHAIRMAN OF THE BOARD OF DIRECTORS OF THE CORPORATION, OR HIS DESIGNEE. THUS, THE INTERESTS OF THE CORPORATION AS A WHOLE ALSO WILL BE REPRESENTED.

THE TRUSTEES APPOINTED BY THE CORPORATION WILL HAVE CUSTODY AND

CONTROL OF THE TRUST TO ADMINISTER, SELL, INVEST AND REINVEST THE TRUST ESTATE. THE TRUST WILL ESTABLISH SEPARATE ACCOUNTING FOR ALL PREFERRED SECURITIES, DEBENTURES, LOSS RESERVES, AND OTHER FUNDS ACQUIRED AND THE APPLICATION OF THOSE FUNDS. THE TRUSTEES WILL MAKE AN ANNUAL ACCOUNTING OF THE TRUST'S OPERATIONS TO THE SECRETARY OF THE TREASURY.

AAMESBIC LEGISLATIVE CHAIRMAN HERBERT P. WILKINS HAS DEVELOPED A COMPUTER MODEL OF THE OPERATIONS OF THE TRUST THAT DEMONSTRATES THE TRUST'S ABILITY TO CONTINUE TO OPERATE FOR THE FULL 50 YEAR PERIOD. MR. WILKINS IS PRESIDENT OF SYNCOM CAPITAL CORPORATION, A WASHINGTON D.C. BASED MESBIC SPECIALIZING IN COMMUNICATIONS INVESTMENTS. THE 50 YEAR COMPUTER MODEL IS ATTACHED TO MY TESTIMONY FOR YOUR REVIEW, BUT I'LL BE DISCUSSING THE FIRST TEN YEARS OF THE MODEL FOR PURPOSES OF DEMONSTRATION.

THE FIRST CHART PROVIDES A BREAKDOWN OF THE MESBIC PORTFOLIO CURRENTLY HELD BY THE SBA. THIS PORTFOLIO WOULD BE TRANSFERRED TO COSBI TO BE HELD IN TRUST FOR A PERIOD OF FIFTY YEARS. THE INCOME GENERATED BY THE PORTFOLIO DURING THE INTERIM WOULD BE USED TO FINANCE NEW MESBIC LEVERAGE. TO ESTIMATE THE INCOME GENERATED BY THE PORTFOLIO EACH YEAR, WE LOOKED AT THE

DEBENTURES MATURING EACH YEAR, PLUS INTEREST EARNED ON NON-MATURING DEBENTURES, ADDED IN EXPECTED DIVIDENDS ON PREFERRED STOCK, AND SUBTRACTED OUT FOR EXPECTED LOSSES AND REMAINING DEBENTURE SUBSIDIES TO BE PAID. I WON'T GO INTO THE DETAILS OF ALL THE ASSUMPTIONS AT THIS POINT, BUT I WILL NOTE THAT THEY ARE CONTAINED IN THE 50 YEAR MODEL ATTACHED TO MY WRITTEN TESTIMONY, AND ARE BASED ON FIGURES OBTAINED FROM THE SMALL BUSINESS ADMINISTRATION'S INVESTMENT DIVISION.

THE FINAL COLUMN IN THIS CHART GIVES THE EXPECTED INCOME GENERATED BY THE PORTFOLIO EACH YEAR. FOR EXAMPLE, THE PORTFOLIO'S INCOME FOR 1986 IS ESTIMATED TO BE $13,468,525. THIS LEADS US TO OUR NEXT CHART.

THIS CHART IS AN ANALYSIS OF THE INCOME AND EXPENSES OF THE TRUST FROM 1986 THROUGH 1995. AT THE TOP WE LIST THE SOURCES OF INCOME FOR THE TRUST. THESE INCLUDE THE INITIAL BALANCE OF THE TRUST, FUNDS GENERATED BY THE EXISTING PORTFOLIO, AND INTEREST EARNED ON MONIES HELD. USING 1986 AS AN EXAMPLE, WE HAVE AN INITIAL BALANCE OF $134,710,454. THIS INCLUDES THE $100 MILLION TRANSFER FROM THE SALE OF FFB ASSETS, PLUS OVER $34 MILLION IN ANOTHER SALE OF ASSETS I WILL DISCUSS IN JUST A FEW MINUTES. THE FUNDS

GENERATED BY THE EXISTING PORTFOLIO IN 1986 ARE APPROXIMATELY $13.5 MILLION, AS WE NOTED FROM THE FIRST CHART. FINALLY, WE HAVE AN ASSUMED INTEREST RATE EARNED ON AVAILABLE FUNDS OF 8%, PROVIDING OVER $11 MILLION IN 1986. TOTAL INCOME FOR THE TRUST IN 1986 IS $159,198,775.

NEXT, WE HAVE TRUST DISBURSEMENTS, WHICH INCLUDE PREFERRED STOCK PURCHASES FROM MESBICs, SUBSIDIES PAID ON DEBENTURES, THE ADMINISTRATIVE FEE PAID TO THE CORPORATION BY THE TRUST, AND FUNDED LOSS RESERVES. AS YOU CAN SEE, THESE DISBURSEMENTS TOTAL TO $23.6 MILLION IN 1986, LEAVING A REMAINING TRUST BALANCE OF APPROXIMATELY $135.6 MILLION. THESE FIGURES ARE BASED ON THE ASSUMPTION THAT BOTH PREFERRED STOCK AND DEBENTURE LEVERAGE THE FIRST YEAR ARE AT $20 MILLION. IN LATER YEARS, DEBENTURES ARE ASSUMED TO GROW AT 7.7% PER YEAR, WHILE PREFERRED STOCK DECREASES 4.25%.

AT THIS POINT, I'D LIKE TO GO BACK TO EXPLAIN THE REMAINDER OF THE INITIAL BALANCE I REFERRED TO EARLIER. AS WE WERE DEVELOPING THE CONCEPT OF THE MESBIC TRUST WITHIN COSBI WE TRIED TO COME UP WITH THE LEAST COSTLY WAY OF CONTINUING TO FINANCE THE MESBIC PROGRAM WITHOUT HAVING TO COME BACK TO THE SMALL BUSINESS COMMITTEES SOME TIME IN THE FUTURE TO REQUEST

ADDITIONAL APPROPRIATIONS. WE WANTED TO DEVELOP A TRULY SELF-SUSTAINING TRUST. WE HAVE ACHIEVED THIS IN SEVERAL WAYS. FIRST, THE COSBI LEGISLATION REQUIRES THAT $100 MILLION OF THE BUDGET SAVINGS AS A RESULT OF THE FFB SALE OF ASSETS BE TRANSFERRED TO THE TRUST. SECOND, THE LEGISLATION ALSO REQUIRES THAT THE EXISTING MESBIC PORTFOLIO BE TRANSFERRED TO THE TRUST FOR A PERIOD OF 50 YEARS. THESE TWO PROVISIONS ALONE WOULD SUSTAIN THE INDUSTRY FOR SOME TIME, BUT NOT FOR 50 YEARS AND NOT AT A HEALTHY GROWTH RATE. WE THEREFORE ADDED AN ADDITIONAL ASSUMPTION TO OUR TRUST. WE WOULD OFFER MESBICs WITH OUTSTANDING PREFERRED THE OPPORTUNITY TO BUY IT BACK AT A DISCOUNT.

BASED ON DISCUSSIONS WITH MESBIC EXECUTIVES, WE BELIEVE APPROXIMATELY 70% OF THE OUTSTANDING PREFERRED WOULD BE PURCHASED. FOR THE PURPOSES OF THIS MODEL, WE HAVE ASSUMED 50% WOULD BUY BACK THEIR PREFERRED THE FIRST YEAR, 10% THE SECOND YEAR, AND 10% THE THIRD. THESE BUY-BACKS GENERATED THE ADDITIONAL AMOUNTS RECORDED UNDER INITIAL BALANCE IN 1986, 1987 AND 1988. THEY ALSO PROVIDE SUFFICIENT FUNDS TO MAKE THE TRUST COMPLETELY SELF-SUSTAINING AT A HEALTHY RATE OF GROWTH FOR A PERIOD OF 50 YEARS. IN THE CHART, YOU CAN SEE WE HAVE A REMAINING BALANCE OF OVER $186 MILLION AT

THE END OF 1995. WHEN THE MODEL IS RUN OUT OVER A 50 YEAR PERIOD, THE TRUST HAS A BALANCE OF $1.7 BILLION, WITH $444.7 MILLION IN CASH, $176.9 MILLION IN PREFERRED STOCK RECEIVABLE, $1.083 BILLION IN FUNDED LOSS RESERVES, AND $16.3 MILLION IN PREFERRED DIVIDENDS RECEIVABLE. THE TRUST ALSO WOULD CARRY A LIABILITY OF $855,236 IN DEBENTURE SUBSIDIES PAYABLE, WHICH COULD BE PAID FROM THE CASH BALANCE. THUS, AT THE END OF THE 50 YEAR PERIOD, THE U.S. TREASURY WOULD RECEIVE A TRUST CORPUS OF SEVERAL HUNDRED MILLION DOLLARS.

THE TRUST REPRESENTS A RELATIVELY SMALL GOVERNMENT OUTLAY TO ACHIEVE SIGNIFICANT RESULTS TOWARDS CLEARLY STATED PUBLIC POLICY GOALS. THE ONE-TIME $100 MILLION TRANSFER, WHICH REPRESENTS APPROXIMATELY TWO AND A HALF YEARS' APPROPRIATIONS TO MESBICS AT OUR CURRENT LEVEL, IS EXPECTED TO SUSTAIN THE SPECIAL INCENTIVES FOR MINORITY INVESTMENTS AND JOB CREATION FOR A FULL FIFTY YEARS. IN ADDITION, THE TRUST'S COVERAGE OF ANY LOSSES COSBI MIGHT INCUR ON MESBIC DEBENTURES WOULD MAKE COSBI A MORE ATTRACTIVE MARKET OPPORTUNITY. ONLY MESBIC DEBENTURES CAN OFFER A GUARANTEE AGAINST LOSSES THROUGH THE TRUST. THE MESBIC PORTION OF COSBI'S PORTFOLIO IS THUS VIRTUALLY RISK FREE IN THE EYES OF OUTSIDE INVESTORS IN THE CORPORATION'S

SECURITIES. THIS FACT, IN TURN, SHOULD LEAD TO INCREASED ACCESS TO CAPITAL MARKETS FOR THE SBIC INDUSTRY AS A WHOLE. THUS, THE ONE-TIME TRANSFER OF $100 MILLION WOULD LEAD TO INCREASED SMALL BUSINESS INVESTMENT, JOB CREATION, AND INNOVATION IN BOTH THE MINORITY AND MAJORITY COMMUNITIES. AND IT WOULD DO SO AT A TIME WHEN OTHER FACTORS, SUCH AS THE PROPOSED ELIMINATION OF CAPITAL GAINS TAX RATES, MIGHT BE DRYING UP OTHER SOURCES OF VENTURE CAPITAL.

## CONCLUSION

IN SUMMARY, COSBI REGULATION AND FUNDING OF THE MESBIC INDUSTRY IS EXPECTED TO OFFER MANY OF THE BENEFITS OF GOVERNMENT REGULATION AND FUNDING IN ADDITION TO MANY NEW BENEFITS. THE COMBINED SHAREHOLDER-ELECTED/PRESIDENTIALLY APPOINTED BOARD WILL OFFER VENTURE CAPITAL EXPERIENCE AND PUBLIC INTEREST REPRESENTATION. THE STABILITY OF FUNDS IS EXPECTED TO BE IMPROVED BY REMOVING THE INDUSTRY FROM ITS RELIANCE ON THE ANNUAL APPROPRIATIONS PROCESS. A LICENSING PROCESS AND MONITORING AND AUDITING FUNCTIONS HAVE BEEN DEVELOPED FOR THE CORPORATION THAT WILL CONTINUE TO SERVE THE PUBLIC POLICY GOALS ACHEIVED BY THE SBA REGULATION OF THE INDUSTRY, WHILE FITTING IN TO THE PRIVATE SECTOR FUNCTIONS OF THE CORPORATION.

AS A RESULT OF THESE CHANGES, THE SMALL BUSINESS INVESTMENT COMPANY INDUSTRY, AND THE SMALL BUSINESSES IN WHICH IT INVESTS, WILL BE BETTER SERVED. MESBICS WILL OPERATE IN A MORE STABLE REGULATORY ENVIRONMENT WITH GREATER ACCESS TO CAPITAL MARKETS THROUGH A FINANCIAL INTERMEDIARY DESIGNED TO MEET THE UNIQUE NEEDS OF SBICS. COSBI WILL PROVIDE ACCESS FOR SMALL BUSINESSES TO THE MAJOR CAPITAL MARKETS, INCREASING THE FLOW OF CAPITAL TO SMALL BUSINESSES BY MANY HUNDREDS OF MILLIONS OF DOLLARS PER YEAR.

I THANK YOU, MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE FOR THIS OPPORTUNITY TO TESTIFY BEFORE YOUR SUBCOMMITTEE AND WOULD BE HAPPY TO ANSWER ANY OF YOUR QUESTIONS.

## MESBIC Trust Analysis

### Intro

The data used to generate the attached model of the MESBIC trust were obtained from Jack Werner, Director of the Office of Investment of the Small Business Administration. These data include: 1) The schedule and report on Section 301(d) SBIC debentures as of December 31, 1985; 2) The balance outstanding on MESBIC preferred stock as of December 31, 1985; 3) The outstanding leverage to operating Section 301(d) SBICs as of December 31, 1985; 4) The Section 301(d) SBIC preferred stock dividends calendar; 5) The total outstanding Section 301(d) SBIC leverage as of December 31, 1985; and 6) The Section 301(d) SBICs paying dividends as of December 31, 1985. It should be noted that the interest rates on the debenture schedule were understated by approximately 3%. Our model compensated for this discrepancy by taking a weighted average of the interest rates on the portfolio of approximately 12%.

### Analysis of Existing SBA Debenture Portfolio

The amount of the existing debenture portfolio maturing each year is given in Column A of the attached table. The reserve for losses on non-operating companies given in Column C was derived by multiplying Column A by 18.58%. This figure represents the ratio of debentures held by non-operating companies to total outstanding debentures. We have thus assumed that approximately 18.58% of the debentures maturing each year will not be paid that year.

Column D represents the interest earned each year on the outstanding MESBIC debentures. As mentioned earlier in the introduction, we are working with a weighted average interest rate of 12%. Thus, in year 1, we would earn interest on the total outstanding portfolio of approximately $100,267,973 which would amount to $12,032,157. ($100,267,973 x 12 = $12,032,157). The 12% interest earned in later years would be applied to a declining balance as the debentures held reached maturity. Column E represents the portion of interest earned that is held by non-operating companies and is derived simply by multiplying the amount each year in Column D by .1858. In other words, Column E represents the amount of interest earned on debentures each year which is estimated uncollectible.

Column F, the remaining debenture subsidy, is taken directly from SBA records. Dividends paid currently, given in Column G, are a constant amount based on the 1985 level. This amount was used as a reasonable estimate because there was no way to accurately reflect the true amount.

Net interest and dividends paid, given in Column H, represents interest earnings (Column D - Column E) less the remaining debenture subsidy (Column F) plus dividend payments (Column G). Finally, to determine the total annual cash flow generated for the trust, the maturing debentures, minus the loss reserve, (Column A- Column C) are added to the net interest and dividends paid (Column H). Thus, the total annual cash flow generated by the existing MESBIC portfolio that would be available to the trust is given in Column I.

MESBIC Trust Analysis

The trust has three sources of funds for investment; 1) The initial amount transferred by Congress; 2) Cash generated by the MESBIC portfolio including buybacks on the existing preferred and calls on the newly issued preferred; and 3) Interest earned on available funds assuming a constant interest rate of 8%. Disbursements from the fund take the form of preferred stock purchases, 3% subsidies on MESBIC debentures, fees paid for administration of the trust, and funded loss reserves, which are an estimated 9% of debentures issued and which are not drawn down in this analysis. In addition, the debentures subsidy assumes an average six month subsidy for new debentures issued each year.

Model

The model examines the operations of the trust over a 50 year period given the following assumptions:

1) The trust receives a $100 million transfer from the FFB sale of assets in year 1.
2) MESBICs are given the option of buying back their existing preferred at 40 cents on the dollar. 50% of outstanding preferred is assumed to be bought back in year 1, 10% in year 2, and 10% in year 3. The income from these sales is reflected under initial balance for these years.
3) Newly issued preferred stock is 3% cumulative, with a 10 year call provision. Preferred stock purchases by the trust are assumed to decrease 4.25% per year, with 82% of the calls recoverable. As the stock is called, it is assumed that the stock is rolled over into a debenture with a 3% subsidy paid by the trust for the first five years.
4) Debentures are assumed to carry a 3% subsidy on the interest rate for the first five years. The amount of debentures issued increases 7.7% per year.
5) Debenture subsidies end after year 45 to prevent the trust from having a debenture subsidies payable liability at the end of the 50 year period.

Given the above assumptions, the model shows that the trust would continue to operate profitably for the entire 50 year period. At the end of 50 years, the trust would have a balance of over $1.7 billion, with $444.7 million in cash, $176.9 million in preferred stock receivable, $1.083 billion in funded loss reserves, and $16.3 million in preferred dividends receivable. The trust also would carry a liability of $855,236 in debenture subsidies payable, which could be paid from the cash balance.

CHART 1

MESBIC TRUST ANALYSIS

AAMESBIC Analysis of Existing SBA Debenture Portfolio

| DEBENTURE MATURITY DATE | AMOUNT MATURING EACH YEAR | % REPAID EACH YEAR | RESERVE FOR LOSSES NON-OPERATING | INTEREST EARNED | LESS INTEREST FROM NON-OPERATING | REMAINING DEBENTURE SUBSIDY | DIVIDENDS PAID CURRENTLY | NET INTEREST AND DIVIDEND PAID | INCOME AND REPAID DEBENTURES |
|---|---|---|---|---|---|---|---|---|---|
| | | | | 12.00% | 18.58% | 3.00% | | | |
| 12/31/85 | 5,921,474 | 5.91% | 1,100,210 | 12,032,157 | 2,235,575 | 1,737,799 | 861,867 | 8,920,650 | 13,741,914 |
| 12/31/86 | 6,398,607 | 6.38% | 1,188,861 | 11,321,580 | 2,103,550 | 1,476,372 | 517,120 | 8,258,779 | 13,468,525 |
| 12/31/87 | 6,271,828 | 6.26% | 1,165,306 | 10,553,747 | 1,960,886 | 990,444 | 448,171 | 8,050,588 | 13,157,110 |
| 12/31/88 | 6,844,612 | 6.83% | 1,271,729 | 9,801,128 | 1,821,050 | 438,912 | 379,221 | 7,920,387 | 13,493,270 |
| 12/31/89 | 4,905,068 | 4.89% | 911,362 | 8,979,774 | 1,668,442 | 61,445 | 379,221 | 7,629,108 | 11,622,815 |
| 12/31/90 | 11,999,758 | 11.97% | 2,229,555 | 8,391,166 | 1,559,079 | 4,937 | 379,221 | 7,206,372 | 16,976,575 |
| 12/31/91 | 8,714,233 | 8.69% | 1,619,104 | 6,951,195 | 1,291,532 | 3,918 | 379,221 | 6,034,966 | 13,130,095 |
| 12/31/92 | 16,197,590 | 16.15% | 3,009,512 | 5,905,487 | 1,097,240 | 2,888 | 379,221 | 5,184,581 | 18,372,659 |
| 12/31/93 | 18,384,390 | 18.34% | 3,415,820 | 3,961,776 | 736,098 | 1,052 | 379,221 | 3,603,848 | 18,572,418 |
| 12/31/94 | 12,582,240 | 12.55% | 2,337,780 | 1,755,660 | 326,200 | | 379,221 | 1,808,671 | 12,053,131 |
| 12/31/95 | 1,883,602 | 1.88% | 349,973 | 245,781 | 45,666 | | 379,221 | 579,336 | 2,112,965 |
| 12/31/96 | 33,968 | 0.03% | 6,311 | 19,749 | 3,669 | | 379,221 | 395,301 | 422,957 |
| 12/31/97 | 34,333 | 0.03% | 6,379 | 15,672 | 2,912 | | 379,221 | 391,982 | 419,936 |
| 12/31/98 | 61,207 | 0.06% | 11,372 | 11,552 | 2,146 | | 379,221 | 388,627 | 438,462 |
| 12/31/99 | 35,063 | 0.03% | 6,515 | 4,208 | 782 | | 379,221 | 382,647 | 411,196 |
| TOTALS | 100,267,973 | 100.00% | 18,629,789 | 79,950,621 | 14,854,825 | 4,717,767 | 6,377,816 | 66,755,844 | 148,394,028 |

CHART 2

| Funds Beginning | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|---|---|---|---|
| Initial balance | 134,710,454 | 142,540,866 | 151,023,726 | 153,719,151 | 154,683,937 | 161,206,508 | 164,694,675 | 174,311,601 | 185,266,593 | 190,613,812 |
| Portfolio funds | 13,468,520 | 13,157,106 | 13,493,268 | 11,622,812 | 16,976,572 | 13,130,093 | 18,372,656 | 18,572,415 | 12,053,129 | 2,112,963 |
| Interest earnings | 11,019,801 | 11,831,613 | 12,728,396 | 13,047,868 | 13,536,430 | 14,142,001 | 14,888,926 | 15,956,628 | 16,867,902 | 17,173,854 |
| | 159,198,775 | 167,529,585 | 177,245,390 | 178,389,811 | 185,196,939 | 188,478,602 | 197,956,257 | 208,840,644 | 214,187,624 | 209,900,629 |
| Disbursements: | | | | | | | | | | |
| Preferred stock | 20,000,000 | 19,150,000 | 18,336,125 | 17,556,840 | 16,810,674 | 16,096,220 | 15,412,131 | 14,757,115 | 14,129,938 | 13,529,416 |
| Debentures subsidy | 300,000 | 923,100 | 1,594,179 | 2,316,930 | 3,095,334 | 3,333,675 | 3,590,368 | 3,866,826 | 4,164,572 | 4,485,244 |
| Administrative fee | 1,500,000 | 1,436,250 | 1,508,063 | 1,583,466 | 1,662,639 | 1,745,771 | 1,833,060 | 1,924,713 | 2,020,949 | 2,121,996 |
| Funded loss reserves | 1,800,000 | 1,938,600 | 2,087,872 | 2,248,638 | 2,421,784 | 2,608,261 | 2,809,097 | 3,025,397 | 3,258,353 | 3,509,246 |
| | 23,600,000 | 23,447,950 | 23,526,239 | 23,705,874 | 23,990,431 | 23,783,927 | 23,644,656 | 23,574,051 | 23,573,812 | 23,645,902 |
| Remaining balance | 135,598,775 | 144,081,635 | 153,719,151 | 154,683,937 | 161,206,508 | 164,694,675 | 174,311,601 | 185,266,593 | 190,613,812 | 186,254,727 |
| COSBI Debentures issued | 20,000,000 | 21,540,000 | 23,198,580 | 24,984,871 | 26,908,706 | 28,980,676 | 31,212,188 | 33,615,526 | 36,203,922 | 38,991,624 |
| Cumulative debs. 107.7% | 20,000,000 | 41,540,000 | 64,738,580 | 89,723,451 | 116,632,157 | 145,612,833 | 176,825,021 | 210,440,547 | 246,644,469 | 285,636,093 |

Debenture reserve 9%
Recoverable preferred 82%

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|---|---|---|---|
| Pref. outstanding | 173,552,268 | 104,131,360 | 90,247,178 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 |
| Cumulative pref. 95.75% | 20,000,000 | 39,150,000 | 57,486,125 | 75,042,965 | 91,853,639 | 107,949,859 | 123,361,990 | 138,119,105 | 152,249,043 | 165,778,459 |
| | 193,552,268 | 143,281,360 | 147,733,303 | 151,405,961 | 168,216,635 | 184,312,855 | 199,724,986 | 214,482,101 | 228,612,039 | 242,141,455 |
| 1st yr. buy-back@50% | 34,710,454 | | | | | | | | | |
| 2nd yr. buy-back@10% | 6,942,091 | | | | | | | | | |
| 3rd yr. buy-back@10% | 6,942,091 | | | | | | | | | |
| Total proceeds | 48,594,636 | | | | | | | | | |

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | | | | |
| Cash | 135,598,775 | 144,081,635 | 153,719,151 | 154,683,937 | 161,206,508 | 164,694,675 | 174,311,601 | 185,266,593 | 190,613,812 | 186,254,727 |
| Debentures rec | 94,346,499 | 87,947,892 | 81,676,064 | 74,831,452 | 69,926,384 | 57,926,626 | 49,212,393 | 33,014,803 | 14,630,413 | 2,048,173 |
| Preferred rec. | 193,552,268 | 143,281,360 | 147,733,303 | 151,405,961 | 168,216,635 | 184,312,855 | 199,724,986 | 214,482,101 | 228,612,039 | 242,141,455 |
| Funded loss res | 1,800,000 | 3,738,600 | 5,826,472 | 8,075,110 | 10,496,894 | 13,105,155 | 15,914,252 | 18,939,649 | 22,198,002 | 25,707,248 |
| Pref. div. rec. | 20,796,219 | 17,289,472 | 15,424,410 | 15,534,590 | 16,038,910 | 16,521,797 | 16,984,160 | 17,426,874 | 17,850,772 | 18,256,655 |
| Total | 446,093,761 | 396,338,959 | 404,379,400 | 404,531,050 | 425,885,331 | 436,561,108 | 456,147,392 | 469,130,020 | 473,905,038 | 474,408,258 |
| **Liabilities** | | | | | | | | | | |
| Deb. subs payable | 5,679,968 | 6,997,424 | 8,444,120 | 9,813,476 | 10,749,511 | 11,759,019 | 12,847,591 | 14,022,042 | 15,288,058 | 16,651,558 |
| Trust balance | 440,413,793 | 389,341,535 | 395,935,280 | 394,717,574 | 415,135,820 | 424,802,089 | 443,299,801 | 455,107,978 | 458,616,980 | 457,756,700 |
| Total liab&bal | 446,093,761 | 396,338,959 | 404,379,400 | 404,531,050 | 425,885,331 | 436,561,108 | 456,147,392 | 469,130,020 | 473,905,038 | 474,408,258 |

| Funds Beginning | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|
| Initial balance | 186,254,727 | 179,908,665 | 195,334,064 | 211,174,568 | 227,397,739 | 243,612,494 | 260,219,877 | 277,222,621 | 294,619,760 | 312,406,100 |
| Portfolio funds | 422,956 | 21,739,936 | 20,852,362 | 19,957,506 | 18,715,592 | 17,920,179 | 17,158,570 | 16,429,331 | 15,731,084 | 15,062,514 |
| Interest earnings | 17,023,559 | 17,701,857 | 19,308,372 | 20,972,964 | 22,680,337 | 24,433,016 | 26,249,743 | 28,133,049 | 30,085,331 | 32,108,820 |
| | 203,701,242 | 219,350,458 | 235,494,798 | 252,105,038 | 268,793,668 | 285,965,689 | 303,628,190 | 321,785,001 | 340,436,175 | 359,577,434 |
| Disbursements: | | | | | | | | | | |
| Preferred stock | 12,954,416 | 12,403,853 | 11,876,689 | 11,371,930 | 10,888,623 | 10,425,857 | 9,982,758 | 9,558,491 | 9,152,255 | 8,763,284 |
| Debentures subsidy | 4,830,607 | 5,202,564 | 5,603,162 | 6,034,605 | 6,499,270 | 6,999,714 | 7,538,691 | 8,119,171 | 8,744,347 | 9,417,662 |
| Administrative fee | 2,228,096 | 2,339,501 | 2,456,476 | 2,579,300 | 2,708,265 | 2,843,678 | 2,985,862 | 3,135,155 | 3,291,913 | 3,456,509 |
| Funded loss reserves | 3,779,458 | 4,070,476 | 4,383,903 | 4,721,464 | 5,085,016 | 5,476,563 | 5,898,258 | 6,352,424 | 6,841,560 | 7,368,360 |
| | 23,792,577 | 24,016,394 | 24,320,230 | 24,707,299 | 25,181,174 | 25,745,812 | 26,405,569 | 27,165,241 | 28,030,075 | 29,005,815 |
| Remaining balance | 179,908,665 | 195,334,064 | 211,174,568 | 227,397,739 | 243,612,494 | 260,219,877 | 277,222,621 | 294,619,760 | 312,406,100 | 330,571,619 |
| COSBI debentures issued | 41,993,979 | 45,227,515 | 48,710,034 | 52,460,707 | 56,500,181 | 60,850,695 | 65,536,199 | 70,582,486 | 76,017,337 | 81,870,672 |
| Cumulative debs. | 327,630,072 | 372,857,587 | 421,567,621 | 474,028,328 | 530,528,509 | 591,379,204 | 656,915,403 | 727,497,889 | 803,515,226 | 885,385,898 |
| Pref. outstanding | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 |
| Cumulative pref. | 178,732,875 | 174,736,728 | 170,910,417 | 167,246,724 | 163,738,738 | 160,379,842 | 157,163,700 | 154,084,244 | 151,135,665 | 148,312,400 |
| | 255,095,871 | 251,099,724 | 247,273,413 | 243,609,720 | 240,101,734 | 236,742,838 | 233,526,696 | 230,447,240 | 227,498,661 | 224,675,396 |
| Calls on pref. | 0 | 16,400,000 | 15,703,000 | 15,035,623 | 14,396,609 | 13,784,753 | 13,198,900 | 12,637,947 | 12,100,834 | 11,586,549 |
| Accrued dividends | 0 | 4,920,000 | 4,710,900 | 4,510,687 | 4,318,983 | 4,135,426 | 3,959,670 | 3,791,384 | 3,630,250 | 3,475,965 |
| | 0 | 21,320,000 | 20,413,900 | 19,546,310 | 18,715,592 | 17,920,179 | 17,158,570 | 16,429,331 | 15,731,084 | 15,062,514 |

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | | | | |
| Cash | 179,908,665 | 195,334,064 | 211,174,568 | 227,397,739 | 243,612,494 | 260,219,877 | 277,222,621 | 294,619,760 | 312,406,100 | 330,571,619 |
| Debentures rec. | 164,571 | 130,603 | 96,270 | 35,063 | 0 | 0 | 0 | 0 | 0 | 0 |
| Preferred rec. | 255,095,871 | 251,099,724 | 247,273,413 | 243,609,720 | 240,101,734 | 236,742,838 | 233,526,696 | 230,447,240 | 227,498,661 | 224,675,396 |
| Funded loss res. | 29,486,706 | 33,557,182 | 37,941,085 | 42,662,549 | 47,747,565 | 53,224,128 | 59,122,386 | 65,474,810 | 72,316,370 | 79,684,730 |
| Pref. div. rec. | 18,645,287 | 18,525,403 | 18,410,613 | 18,300,702 | 18,195,463 | 18,095,696 | 17,998,212 | 17,905,828 | 17,817,371 | 17,732,673 |
| Total | 483,301,100 | 498,646,976 | 514,895,949 | 532,005,773 | 549,657,256 | 568,281,539 | 587,869,915 | 608,447,638 | 630,038,502 | 652,664,418 |
| **Liabilities** | | | | | | | | | | |
| Deb. subs payable | 18,120,048 | 19,701,611 | 21,404,954 | 23,239,455 | 25,215,212 | 27,343,102 | 29,634,841 | 32,103,043 | 34,761,297 | 37,624,236 |
| Trust balance | 465,181,052 | 478,945,365 | 493,490,995 | 508,766,318 | 524,442,044 | 540,938,437 | 558,235,074 | 576,344,595 | 595,277,205 | 615,040,182 |
| Total liab&Bal | 483,301,100 | 498,646,976 | 514,895,949 | 532,005,773 | 549,657,256 | 568,281,539 | 587,869,915 | 608,447,638 | 630,038,502 | 652,664,418 |

| Funds Beginning | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|
| Initial balance | 330,571,619 | 349,100,796 | 367,971,867 | 387,155,987 | 406,616,301 | 426,306,901 | 446,171,669 | 466,142,997 | 486,140,356 |
| Portfolio funds | 14,422,357 | 13,809,407 | 13,222,507 | 12,660,551 | 12,122,478 | 11,607,272 | 11,113,964 | 10,641,621 | 10,189,352 |
| Interest earnings | 34,205,544 | 36,377,292 | 38,625,562 | 40,951,512 | 43,355,900 | 45,839,016 | 48,400,608 | 51,039,800 | 53,754,992 |
| | 379,199,520 | 399,287,495 | 419,819,936 | 440,768,050 | 462,094,679 | 483,753,189 | 505,686,241 | 527,824,418 | 550,084,700 |
| Disbursements: | | | | | | | | | |
| Preferred stock | 8,390,844 | 8,034,233 | 7,692,778 | 7,365,835 | 7,052,787 | 6,753,044 | 6,466,040 | 6,191,233 | 5,928,106 |
| Debentures subsidy | 10,142,822 | 10,923,819 | 11,764,953 | 12,670,854 | 13,646,510 | 14,697,291 | 15,828,983 | 17,047,814 | 18,360,496 |
| Administrative fee | 3,629,334 | 3,810,801 | 4,001,341 | 4,201,408 | 4,411,478 | 4,632,052 | 4,863,655 | 5,106,838 | 5,362,180 |
| Funded loss reserve | 7,935,724 | 8,546,775 | 9,204,877 | 9,913,652 | 10,677,003 | 11,499,133 | 12,384,566 | 13,338,177 | 14,365,217 |
| | 30,098,724 | 31,315,628 | 32,663,949 | 34,151,749 | 35,787,778 | 37,581,520 | 39,543,244 | 41,684,062 | 44,015,999 |
| Remaining balance | 349,100,796 | 367,971,867 | 387,155,987 | 406,616,301 | 426,306,901 | 446,171,669 | 466,142,997 | 486,140,356 | 506,068,701 |
| COSBI debentures issued | 88,174,714 | 94,964,167 | 102,276,408 | 110,151,691 | 118,633,371 | 127,768,141 | 137,606,288 | 148,201,972 | 159,613,524 |
| Cumulative debs. | 973,560,612 | 1,068,524,779 | 1,170,801,187 | 1,280,952,878 | 1,399,586,249 | 1,527,354,390 | 1,664,960,678 | 1,813,162,650 | 1,972,776,174 |
| Pref. outstanding | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 |
| Cumulative pref. | 145,609,123 | 143,020,735 | 140,542,354 | 138,169,304 | 135,897,108 | 133,721,481 | 131,638,318 | 129,643,689 | 127,733,832 |
| | 221,972,119 | 219,383,731 | 216,905,350 | 214,532,300 | 212,260,104 | 210,084,477 | 208,001,314 | 206,006,685 | 204,096,828 |
| Calls on pref. | 11,094,121 | 10,622,621 | 10,171,159 | 9,738,885 | 9,324,983 | 8,928,671 | 8,549,203 | 8,185,862 | 7,837,963 |
| Accrued dividends | 3,328,236 | 3,186,786 | 3,051,348 | 2,921,666 | 2,797,495 | 2,678,601 | 2,564,761 | 2,455,759 | 2,351,389 |
| | 14,422,357 | 13,809,407 | 13,222,507 | 12,660,551 | 12,122,478 | 11,607,272 | 11,113,964 | 10,641,621 | 10,189,352 |

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | | | |
| Cash | 349,100,796 | 367,971,867 | 387,155,987 | 406,616,301 | 426,306,901 | 446,171,669 | 466,142,997 | 486,140,356 | 506,068,701 |
| Preferred rec. | 221,972,119 | 219,383,731 | 216,905,350 | 214,532,300 | 212,260,104 | 210,084,477 | 208,001,314 | 206,006,685 | 204,096,828 |
| Funded loss res. | 87,620,454 | 96,167,229 | 105,372,106 | 115,285,758 | 125,962,761 | 137,461,894 | 149,846,460 | 163,184,637 | 177,549,854 |
| Pref. div. rec. | 17,651,574 | 17,573,923 | 17,499,571 | 17,428,380 | 17,360,214 | 17,294,945 | 17,232,450 | 17,172,611 | 17,115,316 |
| Total | 676,344,943 | 701,096,750 | 726,933,014 | 753,862,739 | 781,889,980 | 811,012,985 | 841,223,221 | 872,504,289 | 904,830,699 |
| **Liabilities** | | | | | | | | | |
| Deb. subs payable | 40,707,621 | 44,028,427 | 47,604,935 | 51,456,835 | 55,605,331 | 60,073,261 | 64,885,221 | 70,067,703 | 75,649,236 |
| Trust balance | 635,637,322 | 657,068,323 | 679,328,079 | 702,405,904 | 726,284,649 | 750,939,724 | 776,338,000 | 802,436,586 | 829,181,463 |
| Total liab&bal. | 676,344,943 | 701,096,750 | 726,933,014 | 753,862,739 | 781,889,980 | 811,012,985 | 841,223,221 | 872,504,289 | 904,830,699 |

| Funds Beginning | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|---|---|---|---|
| Initial balance | 506,068,701 | 525,816,720 | 545,254,878 | 564,233,253 | 582,579,141 | 600,094,410 | 616,552,562 | 631,695,494 | 645,229,924 |
| Portfolio funds | 9,756,304 | 9,341,661 | 8,944,640 | 8,564,492 | 8,200,501 | 7,851,981 | 7,518,271 | 7,198,745 | 6,892,799 |
| Interest earnings | 56,543,758 | 59,402,728 | 62,327,454 | 65,312,261 | 68,350,088 | 71,432,298 | 74,548,478 | 77,686,213 | 80,830,832 |
| | 572,368,763 | 594,561,109 | 616,526,972 | 638,110,006 | 659,129,730 | 679,378,689 | 698,619,311 | 716,580,452 | 732,953,555 |
| Disbursements: | | | | | | | | | |
| Preferred stock | 5,676,161 | 5,434,924 | 5,203,940 | 4,982,773 | 4,771,005 | 4,568,237 | 4,374,087 | 4,188,188 | 4,010,190 |
| Debentures subsidy | 19,774,254 | 21,296,872 | 22,936,731 | 24,702,859 | 26,604,979 | 28,653,563 | 30,859,887 | 33,236,098 | 35,795,278 |
| Administrative fee | 5,630,289 | 5,911,803 | 6,207,393 | 6,517,763 | 6,843,651 | 7,185,834 | 7,545,126 | 7,922,382 | 8,318,501 |
| Funded loss reserve | 15,471,339 | 16,662,632 | 17,945,655 | 19,327,470 | 20,815,685 | 22,418,493 | 24,144,717 | 26,003,860 | 28,006,157 |
| | 46,552,043 | 49,306,231 | 52,293,719 | 55,530,865 | 59,035,320 | 62,826,127 | 66,923,817 | 71,350,528 | 76,130,126 |
| Remaining balance | 525,816,720 | 545,254,878 | 564,233,253 | 582,579,141 | 600,094,410 | 616,552,562 | 631,695,494 | 645,229,924 | 656,823,429 |
| COSBI debentures issued | 171,903,765 | 185,140,355 | 199,396,162 | 214,749,666 | 231,285,390 | 249,094,365 | 268,274,631 | 288,931,778 | 311,179,525 |
| Cumulative debs. | 2,144,679,939 | 2,329,820,294 | 2,529,216,456 | 2,743,966,122 | 2,975,251,512 | 3,224,345,877 | 3,492,620,508 | 3,781,552,286 | 4,092,731,811 |
| Pref. outstanding | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 |
| Cumulative pref. | 125,905,144 | 124,154,175 | 122,477,623 | 120,872,325 | 119,335,252 | 117,863,504 | 116,454,306 | 115,104,998 | 113,813,035 |
| | 202,268,140 | 200,517,171 | 198,840,619 | 197,235,321 | 195,698,248 | 194,226,500 | 192,817,302 | 191,467,994 | 190,176,031 |
| Calls on pref. | 7,504,849 | 7,185,893 | 6,880,492 | 6,588,071 | 6,308,078 | 6,039,985 | 5,783,285 | 5,537,496 | 5,302,153 |
| Accrued dividends | 2,251,455 | 2,155,768 | 2,064,148 | 1,976,421 | 1,892,423 | 1,811,996 | 1,734,986 | 1,661,249 | 1,590,646 |
| | 9,756,304 | 9,341,661 | 8,944,640 | 8,564,492 | 8,200,501 | 7,851,981 | 7,518,271 | 7,198,745 | 6,892,799 |

| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | | | |
| Cash | 525,816,720 | 545,254,878 | 564,233,253 | 582,579,141 | 600,094,410 | 616,552,562 | 631,695,494 | 645,229,924 | 656,823,429 |
| Preferred rec. | 202,268,140 | 200,517,171 | 198,840,619 | 197,235,321 | 195,698,248 | 194,226,500 | 192,817,302 | 191,467,994 | 190,176,031 |
| Funded loss res. | 193,021,193 | 209,683,825 | 227,629,480 | 246,956,950 | 267,772,635 | 290,191,128 | 314,335,845 | 340,339,705 | 368,345,862 |
| Pref. div. rec. | 17,060,455 | 17,007,926 | 16,957,629 | 16,909,471 | 16,863,358 | 16,819,206 | 16,776,930 | 16,736,451 | 16,697,692 |
| Total | 938,166,508 | 972,463,800 | 1,007,660,981 | 1,043,680,883 | 1,080,428,651 | 1,117,789,396 | 1,155,625,571 | 1,193,774,074 | 1,232,043,014 |
| **Liabilities** | | | | | | | | | |
| Deb. subs payable | 81,660,547 | 88,134,728 | 95,107,421 | 102,617,012 | 110,704,842 | 119,415,434 | 128,796,742 | 138,900,411 | 149,782,062 |
| Trust balance | 856,505,961 | 884,329,072 | 912,553,560 | 941,063,871 | 969,723,809 | 998,373,962 | 1,026,828,829 | 1,054,873,663 | 1,082,260,952 |
| Total liab & bal. | 938,166,508 | 972,463,800 | 1,007,660,981 | 1,043,680,883 | 1,080,428,651 | 1,117,789,396 | 1,155,625,571 | 1,193,774,074 | 1,232,043,014 |

| Funds Beginning | 2024 | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 | 2031 | 2032 |
|---|---|---|---|---|---|---|---|---|---|
| Initial balance | 656,823,429 | 666,100,085 | 672,635,653 | 675,952,267 | 675,512,580 | 670,713,316 | 660,878,161 | 645,249,934 | 622,981,979 |
| Portfolio funds | 6,599,854 | 6,319,361 | 6,050,788 | 5,793,629 | 5,547,400 | 5,311,636 | 5,085,891 | 4,869,740 | 4,662,776 |
| Interest earnings | 83,965,130 | 87,069,056 | 90,119,373 | 93,089,275 | 95,947,966 | 98,660,192 | 101,185,730 | 103,478,814 | 105,487,505 |
| | 747,388,413 | 759,488,502 | 768,805,814 | 774,835,171 | 777,007,946 | 774,685,144 | 767,149,782 | 753,598,488 | 733,132,260 |
| Disbursements: | | | | | | | | | |
| Preferred stock | 3,839,757 | 3,676,567 | 3,520,313 | 3,370,700 | 3,227,445 | 3,090,279 | 2,958,942 | 2,833,187 | 2,712,777 |
| Debentures subsidy | 38,551,514 | 41,519,981 | 44,717,019 | 48,160,230 | 51,868,568 | 55,862,447 | 60,163,856 | 64,796,473 | 69,785,801 |
| Administrative fee | 8,734,426 | 9,171,147 | 9,629,704 | 10,111,189 | 10,616,748 | 11,147,585 | 11,704,964 | 12,290,212 | 12,904,723 |
| Funded loss reserve | 30,162,631 | 32,485,154 | 34,986,511 | 37,680,472 | 40,581,869 | 43,706,672 | 47,072,086 | 50,696,637 | 54,600,278 |
| | 81,288,328 | 86,852,849 | 92,853,547 | 99,322,591 | 106,294,630 | 113,806,983 | 121,899,848 | 130,616,509 | 140,003,579 |
| Remaining balance | 666,100,085 | 672,635,653 | 675,952,267 | 675,512,580 | 670,713,316 | 660,878,161 | 645,249,934 | 622,981,979 | 593,128,681 |
| COSB1 debentures issued | 335,140,348 | 360,946,155 | 388,739,009 | 418,671,913 | 450,909,650 | 485,629,693 | 523,023,179 | 563,295,964 | 606,669,753 |
| Cumulative debs. | 4,427,872,159 | 4,788,818,314 | 5,177,557,323 | 5,596,229,236 | 6,047,138,886 | 6,532,768,579 | 7,055,791,758 | 7,619,087,722 | 8,225,757,475 |
| Pref. outstanding | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 |
| Cumulative pref. | 112,575,981 | 111,391,501 | 110,257,362 | 109,171,424 | 108,131,638 | 107,136,043 | 106,182,761 | 105,269,994 | 104,396,020 |
| | 188,938,977 | 187,754,497 | 186,620,358 | 185,534,420 | 184,494,634 | 183,499,039 | 182,545,757 | 181,632,990 | 180,759,016 |
| Calls on pref. | 5,076,811 | 4,861,047 | 4,654,452 | 4,456,638 | 4,267,231 | 4,085,874 | 3,912,224 | 3,745,954 | 3,586,751 |
| Accrued dividends | 1,523,043 | 1,458,314 | 1,396,336 | 1,336,991 | 1,280,169 | 1,225,762 | 1,173,667 | 1,123,786 | 1,076,025 |
| | 6,599,854 | 6,319,361 | 6,050,788 | 5,793,629 | 5,547,400 | 5,311,636 | 5,085,891 | 4,869,740 | 4,662,776 |

| | 2024 | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 | 2031 | 2032 |
|---|---|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | | | |
| Cash | 666,100,085 | 672,635,653 | 675,952,267 | 675,512,580 | 670,713,316 | 660,878,161 | 645,249,934 | 622,981,979 | 593,128,681 |
| Preferred rec. | 188,938,977 | 187,754,497 | 186,620,358 | 185,534,420 | 184,494,634 | 183,499,039 | 182,545,757 | 181,632,990 | 180,759,016 |
| Funded loss res. | 398,508,493 | 430,993,647 | 465,980,158 | 503,660,630 | 544,242,499 | 587,949,171 | 635,021,257 | 685,717,894 | 740,318,172 |
| Pref. div. rec. | 16,660,580 | 16,625,046 | 16,591,022 | 16,558,443 | 16,527,250 | 16,497,382 | 16,468,784 | 16,441,401 | 16,415,181 |
| Total | 1,270,208,135 | 1,308,008,843 | 1,345,143,805 | 1,381,266,073 | 1,415,977,699 | 1,448,823,753 | 1,479,285,732 | 1,506,774,264 | 1,530,621,050 |
| **Liabilities** | | | | | | | | | |
| Deb. subs. payable | 161,501,600 | 174,123,542 | 187,717,374 | 202,357,931 | 218,125,811 | 235,107,818 | 253,397,439 | 273,095,361 | 294,310,023 |
| Trust balance | 1,108,706,535 | 1,133,885,301 | 1,157,426,431 | 1,178,908,142 | 1,197,851,888 | 1,213,715,935 | 1,225,888,293 | 1,233,678,903 | 1,236,311,027 |
| Total liab & bal | 1,270,208,135 | 1,308,008,843 | 1,345,143,805 | 1,381,266,073 | 1,415,977,699 | 1,448,823,753 | 1,479,285,732 | 1,506,774,264 | 1,530,621,050 |

| Funds Beginning | 2033 | 2034 | 2035 | 2036 | 2037 |
|---|---|---|---|---|---|
| Initial balance | 593,128,681 | 538,996,758 | 494,940,671 | 462,975,955 | 445,379,249 |
| Portfolio funds | 4,464,608 | 4,274,863 | 4,093,181 | 3,919,221 | 3,752,654 |
| Interest earnings | 106,515,468 | 107,307,211 | 109,371,838 | 112,912,758 | 118,158,044 |
| | 704,108,757 | 650,578,832 | 608,405,690 | 579,807,934 | 567,289,947 |
| Disbursements: | | | | | |
| Preferred stock | 2,597,484 | 2,487,091 | 2,381,390 | 2,280,181 | 2,183,273 |
| Debentures subsidy | 90,160,057 | 75,591,167 | 59,900,471 | 43,001,592 | 24,801,500 |
| Administrative fee | 13,549,959 | 14,227,457 | 14,938,830 | 15,685,772 | 16,470,061 |
| Funded loss reserve | 58,804,499 | 63,332,446 | 68,209,044 | 73,461,140 | 79,117,648 |
| | 165,111,999 | 155,638,161 | 145,429,735 | 134,428,685 | 122,572,482 |
| Remaining balance | 538,996,758 | 494,940,671 | 462,975,955 | 445,379,249 | 444,717,465 |
| COSBI debentures issued | 653,383,324 | 703,693,840 | 757,878,266 | 816,234,892 | 879,084,979 |
| Cumulative debs. | 8,879,140,299 | 9,582,834,639 | 10,340,712,905 | 11,156,947,797 | 12,036,032,776 |
| Pref. outstanding | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 | 76,362,996 |
| Cumulative pref. | 103,559,190 | 102,757,925 | 101,990,714 | 101,256,110 | 100,552,726 |
| | 179,922,186 | 179,120,921 | 178,353,710 | 177,619,106 | 176,915,722 |
| Calls on pref. | 3,434,314 | 3,288,356 | 3,148,601 | 3,014,785 | 2,886,657 |
| Accrued dividends | 1,030,294 | 986,507 | 944,580 | 904,436 | 865,997 |
| | 4,464,608 | 4,274,863 | 4,093,181 | 3,919,221 | 3,752,654 |

| | 2033 | 2034 | 2035 | 2036 | 2037 |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Cash | 538,996,758 | 494,940,671 | 462,975,955 | 445,379,249 | 444,717,465 |
| Preferred rec. | 179,922,186 | 179,120,921 | 178,353,710 | 177,619,106 | 176,915,722 |
| Funded loss res. | 799,122,671 | 862,455,117 | 930,664,161 | 1,004,125,301 | 1,083,242,949 |
| Pref. div. rec. | 16,390,076 | 16,366,039 | 16,343,022 | 16,320,984 | 16,299,883 |
| Total | 1,534,431,691 | 1,552,882,748 | 1,588,336,848 | 1,643,444,640 | 1,721,176,019 |
| **Liabilities** | | | | | |
| Deb. subs. payable | 204,149,966 | 128,558,799 | 68,658,328 | 25,656,736 | 855,236 |
| Trust balance | 1,330,281,725 | 1,424,323,949 | 1,519,678,520 | 1,617,787,904 | 1,720,320,783 |
| Total liab. & balance | 1,534,431,691 | 1,552,882,748 | 1,588,336,848 | 1,643,444,640 | 1,721,176,019 |

Mr. MITCHELL. If it is all right with the members, I recommend that we hear Mr. Noojin's testimony and then come back to you for questions.

Is that agreeable, gentlemen?

Mr. MCMILLAN. Yes.

Mr. MITCHELL. Good to see you again.

**TESTIMONY OF J. THOMAS NOOJIN, CHAIRMAN, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES**

Mr. NOOJIN. Thank you, Mr. Chairman. I want to also take the opportunity to thank Tom Powers and Christine Russell and Major Clark on the very diligent work they have done in preparation of this bill. And we really appreciate their efforts.

I also want to thank you, Mr. Chairman, for reintroducing this legislation, and my colleagues and counterpart in AAMESBIC.

In the interest of time and because I know the members undoubtedly have some questions that they want to ask, I am just going to cover some of the major changes in the legislation and then respond specifically to the SBA's testimony yesterday.

Mr. MITCHELL. Good. I was going to ask someone to do that.

Mr. NOOJIN. Our written testimony in copious detail has been submitted for the record. I would like to comment first on the Treasury backstop.

Although in the previous legislation and previous testimony we have referred to an analogous situation between Fannie Mae, Sally Mae, and COSBI, that situation no longer exists except to the extent that the backstop would give us agency status. Sally Mae and Fannie Mae have specific authorizations for the Treasury to enter into the purchase of securities from them or provide capital to them should they be in a distressed situation and should it be in the best interest of the Treasury and the Government.

Our backstop requires a specific appropriation from Congress. So even though we have a $500 million implied backstop, Congress would have to specifically appropriate any dollars from the Treasury to honor that backstop.

We have been advised by our people on Wall Street that this particular issue will indeed give our financial instruments agency status. And I would also like to point out in response to the SBA, we have reduced that backstop request from $1 billion to $500 million, Mr. Chairman.

The second item is the purchase of the FFB portfolio. It was originally contemplated that COSBI would give the Treasury a note for that purchase. We have now made the change where the purchase of the FFB portfolio will be in cash, 100 cents on the dollar, at the time COSBI is operational. That cash will come from the sale of COSBI debentures or COSBI financial instruments to the public without the Government guarantee.

So to that extent, the liability or contingent liability that the Government has on the $1 billion FFB portfolio will not be increased.

The legislation also provides for transitional mechanisms where the SBA will not transfer assets to COSBI until they have been notified by COSBI that it is ready for the transfer. Preconditions on

this transfer would be the selection of a 15-man Board of Directors, 5 appointed by the President, 10 by the industry, the satisfactory acquisition of paid-in capital in excess of $15 million.

Eligibility has been addressed. Once we notify the SBA that we are ready for the assets, all SBIC's in good standing would have a reasonable period of time, including up to 3 months after notification of transfer, to purchase stock in COSBI to the extent of 2 percent of their capital. SBIC's not in good standing would continue under the SBA and gradually be liquidated if they were in liquidation.

Those that opt to not join COSBI and that are not leveraged by the SBA would have 2 years to unwind their operations as an SBIC which, as you know, includes provisions such as exemption from the Personal Holding Company regulations and various other tax effects. Those that are leveraged would have an additional 2 years to unwind their operation. And the SBA is given 6 months to promulgate regulations on what would happen thereafter.

Another issue the SBA has raised in the past, and one which we and the various staff members have tried to accommodate, is the issue of regulation as it concerns the protection of small business. So, as a consequence, the major protective regulations have been codified in the COSBI legislation.

Those regulations, in summary, are: SBIC's and MESBIC's can only engage in activities contemplated by the act; there is a prohibition against detrimental conflicts of interest; there are restrictions against SBIC's and MESBIC's from taking control of small business concerns; SBIC investments must be for a minimum of 5 years, with MESBIC's allowed 4 years, as in current legislation; an SBIC can invest no more than 20 percent of its capital in any one small business, that is, diversification statutes, this limit is 30 percent for MESBIC's; financings for the purpose of relending, foreign or passive investments, or the acquisition of farmland are specifically prohibited; and the size standard for small business in which an SBIC and MESBIC can invest is specifically defined by statute.

So these areas that have been of broad concern throughout the history of the SBIC Program, and specifically in testimony from the SBA, have been addressed in the legislation.

Another major concern of the SBA has been regulatory review of COSBI. We have added new provisions to give SBA substantial review authority over COSBI to ensure that the public purposes of the act are carried out. SBA is specifically authorized to review COSBI's criteria for the qualification of SBIC's and rules governing the operations of SBIC's.

In addition, SBA is authorized to examine COSBI's books and records to obtain any necessary information from COSBI, and to report the findings of its reviews to Congress. Thus, if problems develop, SBA will be the first to know about it and will be in a position to immediately alert the House and Senate Small Business Committee so that corrective action can be taken at once.

Of course, we continue to have annual audits, annual reports to the Treasury, and annual reports to the Congress and the President.

With the exception of yesterday's testimony, we feel that most of the major concerns expressed by the SBA in their previous written and oral testimony have been addressed.

As to the administration's annual attempt not only to kill the SBIC Program but the SBA, I would like to just give a couple of examples of why this program is necessary, which dovetails with the questions that were asked by the chairman yesterday.

Last year, in testimony on S. 408 before the Senate Small Business Committee, John Carlson, who is executive vice president and chief financial officer of Cray Research, which as you know is America's premier megacomputer manufacturer, the leader in the world in supercomputers—a company that was started by, among others, many SBIC's in the Minneapolis area—this gentleman gave testimony to the Senate committee as follows:

> Through the success of Cray Research, Inc., the American taxpayer has realized a direct revenue gain of over $100 million in the last 7 years. Cray's total employment has grown to over 2,000 people, with a total payroll of $60 million a year. Despite the company's strength today, however, it came close to failing in 1975 due to a lack of sufficient capital. At that time, venture capital was raised, the majority of which was funded by small business investment companies.
>
> SBIC funding was a make-or-break component of this financing.

He goes on to say that he, could not and had been unable to get the financing from any other source.

In addition, you have all heard of companies such as Apple Computer and Federal Express. Federal Express Corp., which at the time this report was submitted to Congress and the Small Business Committees, was $1.4 billion in sales. It was a raw startup in 1973. It was an innovator of a new product, a new distribution concept. I might report that today Federal Express has $3.5 billion in revenues instead of the $1.4 billion reported here, and their employees number in excess of 20,000.

Five SBIC's, along with Frederick Smith, the entrepreneur, put up the seed capital to start this company. And we all know what a success it is today. Apple Computer, similar.

Here are some names, without giving you more statistics: Intel Corp,. Rolm Corp., Pandick Press, Digital Switch, Network Systems, and many others. Now those are the glory companies of our industry. And everybody is aware of those. And everybody is aware of the glamour associated with venture capital.

I started and ran an SBIC in Jackson, MS, for 10 years back in the seventies and early eighties. And I want to give you some personal experiences about the infrastructure and what market the SBIC's really serve.

There was a company in Columbus, MS, where a gentleman had an idea for disposable hospital supplies back in the early seventies. He was going to use at that time a new technology, a nonwoven fabric to make operating gowns, operating room drapery material, and disposable biodegradable laparotomy sponges. We started that company with $200,000 in SBIC financing and this gentleman's track record, which was about 4 years' experience in a textile company.

At the end of 1978, 4 years into his program, he had extended his bank lines, which at that time were about $1 million, and could find no additional capital. He was employing about 120 people. He

came back to the SBIC's, specifically our SBIC, for additional financing, which we gave him, which enabled him to expand his bank line by an additional $2 million. As you know, in this particular industry we are dealing in piece goods, receivables and inventory financing—unavailable in our part of the country. We had to go to New York to get the bank lines. And the company to make a long story short, grew from $1,400 million in sales to $22 million in sales, from 200 people employed to 1,100 people employed in the next 5 years.

That, in Mississippi, gentlemen, is a major impact on the economy.

Assembly Manufacturing Corp., Sharkey County, MS, the poorest county in the State of Mississippi, and, gentlemen, that is a poor county, I can assure you. We started Assembly Manufacturing Corp. with General Motors MESBIC and our company. It is now 7 years old. It is doing $22 million in sales and employs 600 people at an average wage rate of $10.50 plus benefits, which happens to be $4.70 above the average rate for the State.

One other example, Formcraft Manufacturing, which we started from scratch in 1975, is a business forms manufacturer that specialized in the computer industry. There were no such companies in the Southeast at the time this was started. It grew from zero to $10 million in sales by 1985, had a $5 million asset base, employed 110 people, of which 47 were highly skilled, high-speed, 4-color press operators, none of whom were in the State before this company started. Their average wage was $18 an hour.

Now, these are the type things that are happening in the infrastructure. We hear about the east coast and the west coast and the Boston corridor, et cetera. But the fact is, the SBIC industry has a broad constituency. SBIC's and MESBIC's, made investments in over 5,000 companies last year. The average investment was $125,000.

Our critics say we do not need this program with the broad venture capital community that is now started. They made, gentlemen, 900 investments last year that averaged over $3 million each. So we are in 48 States; they are in far less States. There are no venture capital companies in Alabama, Mississippi, Iowa, et cetera.

So I submit that we serve a constituency and a need that is not available from any other source. And I can tell you from personal experience that the banks in the Southeast and the conventional money sources in the Southeast are not in the market of starting small businesses that grow from zero to 20 people. Everybody will lend to the company that has got 2,000 employees. Very few will lend to our market area.

I would like to address the savings issue, issues brought up by the SBA testimony yesterday. Mr. Turnbull has stated that the creation of COSBI would cost the Government immediately $505 million. Specifically this includes transfer of assets to the MESBIC Trust of $255 million, a $100 million investment in the MESBIC Trust, and a $150 million windfall from the purchase of the FFB debentures.

Of this $255 million in the MESBIC Trust, approximately half of that is preferred stock. If you will recall, Mr. Chairman, you asked for market valuation of that portfolio. This preferred stock is a

noncallable preferred stock that has dividends payable at the option of the issuer, which means that if the MESBIC does not wish to pay dividends on the preferred they do not have to. This, in effect, is a noninterest bearing loan to the industry.

With due respect to the people at the SBA, I hardly think we could value that portfolio at face value under those circumstances. Nevertheless, as my colleague Duane Hill has elaborated this morning, this MESBIC Trust, and these assets will be returned to the Government at the extinguishment of the MESBIC Trust. And I believe these projections as we have looked at them are very valid projections and there is little danger of loss from the current perspective of that portfolio.

The $100 million investment in the MESBIC Trust, as Mr. Hill has pointed out, is less than 2 years', approximately 2 years' appropriations that have already been appropriated for fiscal year 1987 and 1988—or authorized, I am sorry, under the reconciliation bill, for the MESBIC industry. So in a sense, I guess, we are allocating $100 million of the FFB purchase price to the MESBIC Trust, but we are also canceling any future obligation that Congress has already intended that they would fund over the next 2 years.

As to the $150 million windfall in the FFB portfolio, it is true that today the average interest rate is higher than market rate. At least that was the case 2 weeks ago. As you know, interest rates have been moving up now. In 1981, this portfolio carried a discount. We intend to replace maturing debentures with new paper in this particular portfolio. And we do not think that this so-called windfall is realistic but rather a phantom windfall that would not be realized due to the nature and the method by which we would purchase the portfolio and reissue a security.

In addition, we think the $505 million in so-called cost to the Government is a phantom cost because there is no additional liability, there are no additional outlays on the part of the Government and there are no additional contingent liabilities on the part of the Government. There is an implied backstop at the Treasury which we grant could be construed to be an ultimate $500 million liability. Nevertheless, it is not on the books of the Government until it is indeed appropriated by Congress.

Now, we also dispute the method by which the SBA computed these so-called costs to the Government because after reconciliation Congress has expressed its intent to authorize $250 million a year in fiscal year 1987 and 1988 for the SBIC Program. That is $500 million alone that would be curtailed, if not cut out.

In addition, we have, as you pointed out yesterday, Mr. Chairman, $200 million over 5 years just maintaining status quo with the MESBIC industry less $100 million for the allocation from the FFB. So that is $600 million in prospective savings alone, assuming Congress carries out its stated intent.

Now, in addition, this billion dollar portfolio would be purchased with a 100-percent guarantee of the Government. That guarantee already exists on that billion dollar portfolio. It is not a new portfolio. So as this billion dollars matures and is replaced with COSBI debt, the actual exposure to the Government increases.

So we submit, Mr. Chairman, that in fact—I am sorry, decreases, not increases.

Mr. MITCHELL. Yes; decreases.

Mr. NOOJIN. The exposure to the Government decreases not increases. As the debentures mature the guarantee rolls off because they are replaced with nonguaranteed paper issued by COSBI.

So we do not think at any point the Government's exposure will be increased by this legislation. We think it will be diminished from day one. And prospectively, the $500-$600 million between the potential SBIC and MESBIC authorizations which would be there if the program continues in its present status, will offset the approximately $150 million actual value of the transfer of assets that the SBA is referring to and the so-called windfall.

I also want to address the issue of losses. As Mr. McMillan pointed out yesterday, this is a high-risk business, and it is quite different from conventional financing sources. The SBA indicated that they anticipated the industry would have 5- to 6-percent losses. That is over 27 years.

I would also like to point out that despite what the SBA anticipates, the 10-year average losses for the industry are 1.87 percent.

Mr. MITCHELL. SBIC's?

Mr. NOOJIN. SBIC's, yes, sir; 1.87.

So even if the SBA does not recover the portfolio they have in liquidation, and historically they have recovered a significant portion of it, that would give the 27-year loss history of the SBIC Program a 0.0018 loss per year. Now, that is compared to the loan loss reserve for banks on an average of 1.4 percent of assets for the banking industry. As you know, that is a reserve that they are allowed to charge off and maintain at a certain level every year based on history. That is not 1.4 percent a year, but there is no way we have of cumulating these losses.

Needless to say, I think on a relative basis the SBIC industry is in better shape than the banking industry because we at least make equity investments for the risk we take.

Another issue that the SBA pointed out yesterday was that 185 licensees did not have leverage. And, therefore, they concluded that because of that they probably would not want to join COSBI.

Well, if you subtract the written confirmations of intent to join COSBI from the total number of SBIC's, both nonmembers and members of NASBIC, this figure is already diminished by 80 people. So we are looking at 105 out of approximately 380 people who have not expressed a written intent to join COSBI. We feel that we will have an overwhelming majority of the people who desire to join COSBI.

I have personally talked over the last 2 months at regional meetings of our association with about 60 percent of the members who do not use leverage—that's NASBIC members, not total SBIC's and MESBIC's—NASBIC and MESBIC members. In every instance the reply has been that 2 percent of capital paid into COSBI is a small price to pay for continuity of my investment program in this industry.

Further, Mr. Chairman, this 2 percent of capital is only impaired from transfer for 3 years. After 3 years it is a transferable stock item; it can be sold in the marketplace. If our projections are accurate, we think it will be a very viable security in itself similar to

Fannie Mae's, securities that everyone is familiar with. So it is not a permanent lock-in, so to speak.

Mr. McDade and you, Mr. Chairman, asked a question relative to how many jobs have been created by this program. In Mr. Hill's testimony I believe he indicated that calculations by AAMESBIC, had indicated since that program had been started, 1971, they had created approximately 72,000 jobs. An analysis was done for the SBIC industry by Arthur D. Little and Deloitte, Haskins & Sells, covering approximately a 10-year period in the 1970's. They indicated that jobs in the SBIC industry were created at the rate of one per $6,500 of investment by SBIC's. Obviously, before 1970 that was less, and after 1980 that was more.

But on balance, we think in taking those variances into consideration and based on that study, we feel that conservatively, over the 27-year life of the program, which is a pure extrapolation, partially borne out by these figures that I gave you earlier, that over 900,000 jobs have been created by this program.

Mr. McDade asked the question how many new businesses had been started? SBIC's have been reporting the age and type company they have been investing in since 1960. And over the term of this period, SBIC's have invested in approximately one-third of their portfolio in startup companies or companies less than 1 year old. So we estimate that over the $6 billion—$6-plus billion investments that have been made by the SBIC industry alone that 22,000 to 23,000 new companies have been financed during the life of the program.

Here again, we do not have access to those reports to the SBA. And we have extrapolated this number from the annual report the SBA makes through their SBIC Digest. So approximately one-third of the businesses are startup or less than 1 year old.

To conclude rapidly, Mr. Chairman——

Mr. MITCHELL. Take your time.

Mr. NOOJIN [continuing]. With the implied backstop and the market forces that we think will enforce a discipline on COSBI's management and, indeed, the whole industry, because if we do not manage this program effectively the market will reflect that in our paper, and if we cannot sell paper we do not have the program, and this COSBI legislation, that SBIC's will continue to serve a broad-based small business constituency that creates jobs and obviously enhances American competitiveness.

The continuation of existing SBA regulations, political uncertainty surrounding the SBA will force the strongest people, the strongest companies from this industry and destroy the program as we know it today.

Thank you, Mr. Chairman.

[Mr. Noojin's prepared statement, with attachments, follows:]

## PREPARED STATEMENT OF J. THOMAS NOOJIN, CHAIRMAN, NASBIC

**MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:**

I am Thomas Noojin, Chairman and President of Hickory Venture Capital Corp. which is located in Huntsville, Alabama. Hickory was organized in March of 1985 as a subsidiary of First Tennessee Bank of Memphis, and capitalized at $4 million. For the ten years prior to joining Hickory, I was chief executive officer of Invesat Capital Corporation, an SBIC in Jackson, Mississippi. During this year I am also serving as Chairman of the National Association of Small Business Investment Companies (NASBIC), which represents the overwhelming majority of all licensed Small Business Investment Companies (SBICs).

INTRODUCTORY COMMENTS

I am delighted to return with Duane Hill, Chairman of the American Association of MESBICs (AAMESBIC), to this second hearing on the proposed legislation to create the Corporation for Small Business Investment (COSBI). As I indicated in my prior testimony, the COSBI proposal has been developed through a joint-partnership effort between AAMESBIC and NASBIC, and both organizations fully support this legislation.

We very much appreciate your reintroduction of the revised COSBI bill and the Committee's efforts to move the legislation through the hearing and enactment process in an expeditious fashion. We are once again elated by the strong bipartisan co-sponsorship of 38 members of the Small Business Committee.

A special word of thanks is owed to the Committee staff. Major Clark, Tom Powers and Christine Russell have worked very hard to refine and improve this legislation. We appreciate their very positive and cooperative attitude, and the time and effort they have extended to perfect the bill.

TODAY'S TESTIMONY

The hearing in December covered the all of the concepts of COSBI in some depth and detail, and it would seem reasonable that we need not retrace all that ground again. Consequently, while I will quickly review the most important of those concepts, my testimony today will concentrate on what we see as the key issues in the legislation and the major improvements that have been made in the bill from the previous version (H.R. 3484).

WHY COSBI IS NECESSARY

As I noted at the last hearing, we are very proud of the SBIC industry's track record. Our industry has been a major source of risk capital for a wide variety of small businesses in

geographically diverse sections of the country for more than 27 years. Today, over 500 SBICs and MESBICs, with assets in excess of $2 billion, are actively providing seed capital to help thousands of small, job-creating companies grow and prosper.

Despite this successful record, however, the SBIC program has reached a critical crossroads. For the past several years, uncertain funding and restrictive allocations of scarce dollars have made the SBIC financial-support process unreliable, while continually changing government policies have created an unstable operating atmosphere which is counterproductive to long-term investing.

Finally, as the ultimate insult to the success of the SBIC program, for the past two years the Administration has proposed that the program be terminated. The Administration has proposed a complete shut-down of this valuable source of risk capital for small business.

Buffeted by these threats to close down the program, destabilizing policies and uncertain access to leverage; we have concluded, as prudent business men and women, that it is absolutely essential to privatize the SBIC program and bring stability and predictability to our industry.

COSBI is the creative facility that will produce that result.

Let me quickly add that credit for the concept of privatizing the SBIC program should be given to the Congress. In 1967, with great wisdom and foresight, the Congress added a provision to the Small Business Investment Act of 1958 which specifically requires SBA to make:

> ". . recommendations with respect to the feasibility and organization of a small business capital bank to encourage private financing of small business investment companies . . ."

It's ironic that after a period of nineteen years in which SBA failed to make a single constructive recommendation on privatization, the SBIC industry is stepping forward with a specific proposal to carry out the intent of Congress, and the SBA is waging war against the idea.

## COSBI -- IN SUMMARY

I will quickly review the basic features of COSBI. (The terms "COSBI" and "Corporation" are used interchangably.)

### Purpose

COSBI is designed to operate as a privately owned and managed, special-purpose financial institution, with the mission of providing a stable flow of long-term capital and an effective operating environment for the SBIC industry.

### Agency Status

The Corporation will have the status of a government-sponsored enterprise, or "agency," similar to the Student Loan Marketing Association (SLMA) or the Federal National Mortgage Association (FNMA). The features of government sponsorship include: creation by an act of Congress, public representation on the Board of Directors, exemption from securities registration, exemption from state and local taxes, stock of the Corporation eligible for purchase by regulated depository institutions, obligations of the Corporation eligible as collateral for public funds, and a "backstop" by the U.S. Treasury.

### Capitalization and Management of COSBI

COSBI will be managed by a fifteen member Board of Directors, with ten directors elected by the stockholders and five directors appointed by the President. The Corporation will be capitalized with $20 million, raised through the sale of common stock to SBICs. Each SBIC will be offered the right to purchase stock in an amount not to exceed 2% of its private capital. COSBI will be able to raise additional capital as a

result of growth in the industry, and it is authorized to sell preferred stock and non-voting stock should markets for those stocks ever materialize.

**Purchase of FFB Portfolio**

In order to provide COSBI with an initial asset base of sufficient size to gain recognition in the capital markets, the Corporation will purchase the portfolio of SBA-guaranteed SBIC debentures held by the Federal Finance Bank (FFB). This purchase of assets will produce substantial savings in the Federal budget.

**SBIC Participation**

All SBICs in good standing with SBA at the time the Corporation commences operations will be eligible to purchase stock in COSBI and participate in the new program. COSBI will establish qualification standards for newly-organized SBICs.

**Funding for SBICs**

COSBI will give SBICs needed access to a stable source of funds. The Corporation's "agency" status will enable COSBI to sell its securities in the capital markets at competitive yields. In turn, COSBI will be able to provide funds to qualified SBICs on reasonable terms, and COSBI will be able to employ a variety of securities instruments which match the financial needs of SBICs. This assured source of affordable capital will increase the SBIC industry's capacity to make continued venture capital investments in small business.

**Regulation of SBICs**

The operations of SBICs will be governed by a series of regulatory provisions which have been codified in the bill, and by no-nonsense standards of entry and business conduct established by COSBI's Board of Directors. SBIC business practices will be controlled through a contractual arrangement between COSBI and each SBIC. This operating environment will provide the long-term policy continuity necessary for the effective management of SBICs.

**Oversight of COSBI**

As a government-sponsored enterprise, COSBI's business and financial performance will be subject to several forms of review. The Corporation's activities will be monitored to assure the public purposes of the legislation are carried out. In addition, the accounts of COSBI will be audited annually by an independent certified public accountant; annual reports on COSBI's operations will be submitted to SBA, the Secretary of the Treasury, the President and the Congress; and COSBI will be subject to legislative oversight by the Small Business Committees of the Congress.

We are confident that COSBI, operating in the risk-reward system of the private marketplace, will generate a major increase in the flow of venture capital to small business and will establish a climate for significant expansion of the SBIC industry.

**KEY POINTS AND MAJOR CHANGES**

As the Committee knows, we have been working on the COSBI proposal for several years. Because it is a complex and dramatic departure from the current structure of the program, with significant implications for the future of our industry, we have exercised great care to assure that we have crafted the most solid piece of legislation possible.

We have spent countless hours consulting with experts; raising and resolving issues; and refining, adjusting and perfecting the bill. Your hearing on the previous version of the legislation and the highly professional work of the Committee staff have been extremely helpful in this process.

We have drawn on the expertise of budget specialists, accountants, legal counsel and investment bankers with extensive experience in this area. We have consulted with senior officials at other government-sponsored agencies, the SBA and other

elements of the Administration. We have worked closely with, and recieved substantial support from, numerous small business and financial trade associations and groups. Most importantly, throughout this process we have kept all SBICs and MESBICs deeply involved, both members and non-members of our associations.

As a result of these efforts, we concluded that there are five major points in the COSBI proposal which warrant special consideration at this hearing. Because each of these items is essential to the success of COSBI, and because improper treatment of any one of them could unravel the bill, I would like to take the time today to explain our position on each of these points.

1. **The Treasury "Backstop"**

Every version of the COSBI legislation has provided for some form of a financial "backstop" by the U.S. Treasury. This feature had been patterned after similar backstop provisions provided to other federally-sponsored agencies, such as the Student Loan Marketing Association (SLMA) and the Federal National Mortgage Association (FNMA).

Generally speaking, a Treasury backstop provision says that if the agency in question gets into serious financial difficulty, the Federal Government, via the U.S. Treasury, may, in its discretion, step in to provide support for the agency until it is turned around and restored to a sound financial position. It is not a guaranty by the Federal Government!! It is not a line-of-credit that can be drawn down by the agency!!

The purpose of a backstop is fairly straightforward. To the investment community it has become a key distinguishing factor in the sale of agency securities. Institutional and other sophisticated investors view it as a major comfort factor in their pricing and evaluation of these securities. To them, the backstop, coupled with other features of government sponsorship, creates a perception that the public purposes of the agency are important enough that the Federal Government won't let it fail, and it provides a clear indication that the government will

protect the agency's credit position and will step up to the line with financial support if that becomes necessary.

The form of backstop provided to FNMA and SLMA give the Secretary of Treasury unrestricted discretion, within specified dollar limits, to provide financial support to those agencies, if needed. The backstop in our original COSBI bill was designed that way. Even though none of tnese agency backstops have ever been used, and aren't expected to be, critics of this form of support argue that it is tantamount to a contingent liability of the government, should be considered an "on budget" item, and should be scored for budget purposes, particularly in light of recent budget acts, including Gramm-Rudman-Hollings.

Several members of this Committee have expressed a similar concern with the backstop provision which was in the previous COSBI bill. Others asked if the backstop was essential, or if it could be phased-down or terminated by a sunset provision at some date certain.

We have made an extensive effort to resolve this issue, and I'm convinced we've been successful.

Is the backstop essential? We believe the answer is clearly "yes," it is essential. The investment banking community has advised us that a backstop provision is the single most important item to investment managers who determine whether a security qualifies as an investment grade "agency" security, and the absence of a backstop would severly injure the financial capacity of a new facility like COSBI as it attempted to sell its securities. Without the backstop, the sale of COSBI's securities would be either virtually impossible or the pricing so extreme that COSBI's feasability would be very questionable.

Can the backstop be phased-out or sunseted? The answer is "no," because a phase-out or sunset feature would be perceived to negate the effect of the backstop. Any type of termination feature would be interpreted by investment managers as a voiding of the implied commitment of the government, making a phased-out

or sunseted backstop worthless.

In summary, we've concluded that a backstop is essential to the success of COSBI. The next step was to restructure the backstop provision in a way that would remove the budget scoring/contingent liability problem. Two significant changes have been made. First, and most important, the backstop authority has now been made subject to the appropriations process, and its discretionary use eliminated. That is, Congress must pass legislation specifically appropriating funds before the Secretary of the Treasury can use the backstop authority. The backstop provision was re-fashioned in this manner to assure Congress that the backstop did not represent a fait accompli; that no financial assistance would be given to COSBI without the direct approval of Congress.

In addition, while a defined ceiling on the amount of the backstop has been retained, the dollar amount has been reduced from $1.0 billion to a far more acceptable level of $500 million.

We understand that the House Budget Committee has officially determined that the revised version of the backstop in H.R. 5019 would not be scored as budget authority or outlays. At the same time, the investment banking community has advised us that this revised form of backstop authority will continue to be satisfactory for purposes of marketing COSBI's securities. Consequently, we believe the issues related to the backstop have been resolved.

2. **Purchase of the FFB Portfolio**

Each version of the COSBI legislation has had a provision under which the Corporation would purchase the roughly $1.0 billion of outstanding SBIC debentures held by the FFB. Generically, this transaction involves a governmental "sale of assets" which is somewhat analagous to the asset sales suggested by the Administration as a way to achieve budget savings.

This particular sale of assets to COSBI, however, has

several critical differences.

Many, if not all, of the asset sales proposed by the Administration appear to be randomly selected, with no substantive, program-related purpose.

COSBI's acquisition of the SBIC debentures held by FFB, on the other hand, serves a very important purpose for the SBIC program, small business and COSBI. The Corporation will finance the purchase of the FFB portfolio through the issuance of securities in the capital markets. This transaction will give COSBI an initial asset base and immediate recognition in the capital markets, factors the investment banking community feels are very important to the ultimate success of COSBI.

The Administration has suggested selling SBA and other loan assets at 20¢ on the dollar, or less. These proposals have been heavily criticized as penny-wise and pound-foolish "fire sales" because, while they create the appearance of short-term savings, the government actually ends up losing a significant part of the long-term value of the assets being sold.

The COSBI legislation resolves this problem by providing for a true, par value asset sale. Under our proposal, COSBI will buy the SBIC debentures held by FFB, on a guaranteed basis, for 100¢ on the dollar, and COSBI will assume responsibility for servicing those debentures. COSBI will pay full face value for the outstanding debentures. For $1.0 billion in SBIC debentures, COSBI will pay $1.0 billion in cash. Treasury can then invest that $1.0 billion and earn interest on it, or Treasury can use the $1.0 billion to reduce the borrowings on which it pays interest.

In order to insure that appropriate budget "scoring" for this sale of loan assets is achieved, several perfecting changes have been made in this section of the bill. The legislation provides that COSBI will purchase the portfolio during fiscal year 1987. It also specifies that the debentures being purchased are those that mature during fiscal year 1988 and thereafter.

These two changes allow CBO to determine the exact budget impact of the sale.

Rather than approaching it piecemeal, I will cover the savings produced by the various elements of the legislation later in my testimony.

There is one additional change in this section of the bill that merits special mention. The old version of the COSBI bill authorized a direct $100 million appropriation to fund the MESBIC Trust. The revised version of the bill now provides that $100 million of the amount COSBI pays for the SBIC debentures shall be paid over to the MESBIC Trust, rather than being paid to Treasury. This offset of a portion of the purchase proceeds avoids the need for Congress to appropriate that amount for the Trust.

3. **The MESBIC Trust**

H.R. 5019 retains and strengthens the special-purpose Trust for the MESBIC program. The Trust is designed as a mechanism which can continue to provide the special financial benefits currently available to the MESBIC industry, namely leverage by way of preferred stock and reduced rate debentures.

A series of perfecting changes have been made in the MESBIC Trust section of the bill. The statute now specifically provides for authorization and creation of the Trust; the make-up of the five-member Board of Trustees is spelled out, including the fact that three of the trustees must be from MESBICs; and a specific voting procedure is provided through which MESBICs will nominate the three trustees from the MESBIC industry. In addition, a clause has been added under which the trustees are required to administer the Trust under a "prudent man" standard; the timing for SBA's transfer of the MESBIC assets it holds to the Trust is triggered by COSBI's notice to SBA that it is prepared to conduct business; and the provision for termination of the Trust after fifty years has been made more specific.

We are convinced the Trust will be a very effective vehicle to provide essential support for the MESBIC industry, with no negative implications for the financial position of COSBI.

Mr. Hill will provide the Committee with details on how the Trust will operate.

4. **The Transition to COSBI**

A number of uncertainties existed under the previous version of the legislation regarding the conversion from the present SBA-administered program to COSBI, and the process by which an existing SBIC would make the transition to COSBI's jurisdiction. Perfecting changes have been made in H.R. 5019 to assure a smooth transition from the present statutory authority to operations under COSBI.

The bill provides that COSBI's authority to finance and regulate SBICs will only go into effect when certain specified events occur. COSBI becomes operational when the Corporation has raised its initial capital, elected a permanent Board of Directors and given notice to SBA that it is ready to conduct business. After those transition actions have been taken, SBA's financial and regulatory authorities no longer apply to SBICs that qualify to do business with COSBI.

As to currently licensed SBICs, only those "in good standing" with SBA can qualify to do business with COSBI. SBICs that are in financial default to SBA or have been placed in a liquidation status for regulatory reasons cannot qualify, and will remain in the normal SBA liquidation process.

An SBIC "in good standing" can qualify to do business with COSBI if it (1) invests in COSBI stock, (2) enters into a contractual agreement to be regulated by COSBI and (3) authorizes the release of its SBA-held records to COSBI. SBICs in good standing are given an ample period of time to qualify with COSBI. They will be able to qualify anytime from the passage of

the bill until three months after the date COSBI gives notice to SBA that it is ready to conduct business.

In addition, the provisions relating to SBICs that elect not to qualify with COSBI are clarified and spelled out in more detail. SBA is given a period of six months to promulgate final rules and regulations which spell out the process for winding down the operations of these SBICs. Those SBICs with no financial obligation to SBA have a two-year period to wind down their operations. SBICs that do have outstanding debt with SBA are given a wind-down period which extends two years beyond the date the debt is due or paid.

5. **Oversight of COSBI and the SBIC Industry**

The original COSBI legislation adopted a set of review and oversight activities which have been commonly applied to other government-sponsored enterprises. These included public appointees on the Board; an annual audit of COSBI by an independent CPA; Treasury review of COSBI's financial condition, and access by Treasury to COSBI's books and records; annual financial and program reports to the House and Senate Small Business Committees, the President and the SBA Administrator; and the regulation of SBIC business practices by way of a contract between COSBI and each SBIC. In addition, that version of the bill re-codified several of the restrictions on SBIC activities found in the Small Business Investment Act of 1958, such as the prohibition against conflicts of interest.

In essence, our original approach to the regulatory aspects of the COSBI legislation was one of industry "self-regulation" within defined statutory parameters, and with limited direct oversight by the government.

We felt that approach was justified for several reasons. From a financial perspective, COSBI will be capitalized solely with private funds from the SBIC industry; investors in SBICs will have $1 billion of private capital at risk under COSBI; the

federal guaranty will no longer be attached to any future SBIC leverage; and the singular source of funds for the industry the future will be the private capital markets, not the government.

From the regulatory perspective, we are convinced that the professional industry leadership elected to COSBI's Board of Directors will do a far better job of regulating the business practices of SBICs than any group of government regulators. When the knowledge and awareness of these professional SBIC managers is coupled with an absolutely compelling self-interest in keeping the industry free from abusive practices, those factors create a tremendous incentive for consistent and diligent oversight and strong enforcement of proper business practices.

However, as a result of our continuing discussions of COSBI with House and Senate Small Business Committee members and staff, officials at SBA and others, it has become very clear that moving from an environment of complete, hands-on government regulation to one of self-regulation would not be acceptable at this time.

Recognizing this reality, several major changes in the legislation have been made which we believe resolve all of the stated concerns about oversight and regulation of the industry.

First, the major SBA regulations which currently govern the operations of SBICs have been codified in very specific terms in the statute. These codified regulations include:

- SBICs can engage only in activities contemplated by the Act.

- The prohibition against detrimental conflicts of interest has been broadened.

- The restrictions against SBICs taking control of small business concerns has been made more explicit.

- SBIC investments must be for a minimum period of five years, and MESBIC investments must have a four year term.

- An SBIC can invest no more than 20% of its capital in any one small business. This investment limit is 30% for MESBICS.

- Financings for the purpose of re-lending, foreign or passive investments, or the acquisition of farm land are specifically prohibited.

- The size standard for a small business in which an SBIC can invest is specifically defined by the statute.

The COSBI contractual relationship which will govern the business practices of SBICs has been retained, and COSBI's authority to enforce compliance with its rules and regulations has been clarified, broadened and strengthened.

In addition, SBA has been brought back into the COSBI scenario. New provisions have been added which give SBA substantial review authority over COSBI to insure that the public purposes of the Act are carried out. SBA is specifically authorized to review COSBI's criteria for the qualification of SBICs and COSBI's rules governing the operations of SBICs. In addition, SBA is authorized to examine COSBI's books and records, to obtain any necessary information from COSBI, and to report the findings of its reviews to Congress. Thus, if problems develop, and SBA is doing its job, SBA will be the first to know about it and will be in a position to immediately alert the House and Senate Small Business Committees so that corrective action can be taken at once. From a Congressional oversight perspective, this would seem to be ideal.

However, because the system can work and remain viable only if it has one regulatory overseer, SBA's review authority stops at the level of COSBI and does not extend to the operations of individual SBICs. Those problems, if any, will be for COSBI and the Congress to control and correct.

We are convinced that this approach to oversight and

regulation of the system is the right one, and that it is a sound, reasonable compromise that will work and produce the results desired by the Committee.

## COSBI's IMPACT ON THE FEDERAL BUDGET

Earlier in my testimony I pointed out how COSBI will be of enormous benefit to small business, the venture capital process and the economy as a whole. In addition to those broad economic benefits, the Federal government will also realize a number of immediate and substantial financial gains when the SBIC program is privatized through H.R. 5019.

### Budget Savings

The House Budget Committee has indicated that the net result of the sale of the FFB-held SBIC portfolio to COSBI would be a "substantial reduction in the deficit in the year of the sale."

Although no final calculations of budget savings have yet been prepared by the Budget Committees and the Congressional Budget Office (CBO), we believe COSBI will generate budgetary savings in excess of $500 million.

This estimate of savings, which we believe to be quite conservative, is based on discussions with the House Budget Committee and CBO, which have provided guidance as to how the more complex items in the bill would be scored.

We have prepared a chart with a breakdown of the items included in our savings estimate. The chart is attached as an addendum to my testimony. As the chart demonstrates, the major positive items are the cash purchase of the SBIC debentures and the termination of current-law budget authority for the MESBIC program. Together, these items produce a positive budget impact of over $1.0 billion.

### Additional Financial Benefits

In addition to the specific budget savings that would be

generated by COSBI, I would like to point out to the Committee several additional financial benefits that COSBI will create for the Federal government that don't show up on the budget scorecard:

o You will note that one item on the chart is entitled "Interest realized from investment of cash proceeds," which refers to the Treasury's use of the $825 million in cash it will receive from the sale of the FFB portfolio. We understand that the earnings on these funds technically may not be "scored" for budget purposes as savings in SBA's budget function. However, it seems apparent to us that Treasury can either invest these funds and earn interest, or use these funds to retire outstanding debt and save interest costs. In either case, use of this cash asset will produce real income to the Treasury and real savings of over $200 million which can be directly attributed to H.R. 5019.

o The SBIC industry currently has private capital of roughly $1 billion. The Small Business Investment Act of 1958 authorizes the SBA to provide leverage to SBICs on a ratio of up to $4 for every $1 of private capital. However, SBICs have only drawn down $1.0 billion. Essentially, this means the government has an outstanding commitment to provide an additional $3 billion in leverage to the SBIC industry. By converting to COSBI, the industry is voluntarily relieving the government of any obligation to provide that $3 billion, and demonstrating our willingness to raise any capital we need in the future on our own.

o Likewise, if the government's commitment to the highly popular MESBIC program were to continue for another 20 years at an average annual level of $50 million, the total direct appropriations involved would be $1 billion. The prospect for these continuing outlays also disappears under COSBI.

o The SBIC program has proven to be one of the most profitable endeavors the government has ever initiated in terms of the new tax revenues the industry has produced over 27 successful years of operation. If our projections of industry growth and expanded flows of capital to small business are correct, COSBI will be an even more productive engine for the generation of new tax revenues.

o COSBI will assume all of the financial, regulatory, administrative and servicing costs and responsibilities for operating the program.

o Most important, by placing its $1 billion of privately invested capital on the line, the industry will assume the paramount risk that COSBI will work.

When these factors are coupled with the $500 million of "scored" savings, I'm convinced you will agree that COSBI, as a total package, is clearly a "win-win" proposition for the Federal government.

THE ADMINISTRATION's OPPOSITION TO COSBI

In light of the Administration's current recommendation to terminate the SBIC program and SBA's official position on prior versions of the COSBI legislation, we have assumed, for purposes of this testimony, that the Administration will oppose H.R. 5019.

We are, of course, extremely disappointed that the Administration has opposed COSBI. This opposition is particularly disturbing in light of the Administration's continued pronouncements in favor of (1) "privatizing" government programs, (2) reducing government regulation of private industry and (3) reducing the federal deficit -- three basic concepts which are interwoven into the fabric of COSBI.

SBA's official position on prior COSBI bills is contained in

letters to Senator Lowell Weicker, Chairman of the Senate Committee on Small Business, dated December 11, 1984 and January 21, 1986. (Copies of these letters will be submitted for the record.)

My comments will relate primarily to the letter of December 11, 1984, which provides a detailed statement of SBA's position on the bill. The January 21, 1986 letter makes reference to the prior letter and adds little of substance. According to our analysis, SBA raised twelve specific points relating to the prior versions of the legislation - four technical points, six substantive issues and two conceptual concerns. I would like to comment on each of these for the record (using the respective headings in the SBA letter).

**Technical Points** - The four specific technical points raised by SBA have been addressed and corrected in H.R. 5019.

1. Approval of the Secretary of the Treasury - SBA suggested that COSBI's issuance of securities be subject to "approval of," rather than "consultation with," the Secretary of the Treasury.

H.R. 5019 makes the issuance of COSBI securities subject to "approval of" the Secretary of the Treasury.

2. SBA Authorizations and Appropriations - SBA suggested that the legislation specify that non-qualifying SBICs would not be eligible for refunding, new leverage or available tax advantages.

H.R. 5019 addresses this concern by clearly spelling out the procedure for dealing with non-qualifying SBICs, including specific language that they will no longer be eligible for leverage.

3. Treasury Authorization to Purchase COSBI Obligations - SBA suggested that the Treasury "backstop" provision be

clarified to ensure that it would be used only to protect the credit standing of COSBI and not to refund SBIC obligations to COSBI.

Under H.R. 5019, not only has the "backstop" been reduced by half, but it is also made clear that the Secretary of Treasury can use this authority only if Congress specifically appropriates funds for this purpose.

4. Effect on Other SBA Programs - SBA pointed out that certain repeal provisions in the original bill impaired SBA's ability to investigate participants in other SBA financial programs.

H.R. 5019 corrects this inadvertent drafting error.

**Substantive Issues** - SBA also raised six specific points involving more substantive issues. H.R. 5019 has specifically addressed and resolved three of these concerns.

1. Regulation of COSBI - SBA suggested that so long as COSBI had any financial obligation to the Treasury, or the "backstop" was available to assist the Corporation, COSBI should be regulated directly by the Federal Government and be subject to audits by the GAO.

Prior versions of the COSBI legislation proposed that COSBI give Treasury a note for the purchase of the FFB-held SBIC portfolio. Under this form of transaction, the Corporation would have had a continuing financial obligation to the Treasury until the note was paid. Under H.R. 5019, however, purchase of the FFB portfolio will be accomplished through a cash transaction. No note will be involved, so no financial obligation to Treasury will arise from the transaction.

In addition, no other COSBI obligation to Treasury will occur unless the backstop authority is used, which is highly

unlikely. If it were to be used, either Congress, in appropriating funds, or the Secretary of Treasury, in exercising his authority, or both, could subject COSBI to any regulatory or audit conditions they deem appropriate.

Moreover, H.R. 5019 provides a specific system for oversight of COSBI's operations to ensure that the public purposes of the Act are carried out. SBA is given specific authority to review COSBI's operations; COSBI is subject to audit by the GAO at the request of either the House or Senate Small Business Committees; the accounts of COSBI will be audited annually by an independent certified public accountant; annual reports on COSBI's operations will be submitted to several government agencies; and COSBI is subject to legislative oversight by the Small Business Committees of the Congress.

2. Assignment of Assets - Assumption of Debts - The prior version of the COSBI bill provided for a negotiated assignment of the SBIC debentures held by FFB, with a note given to Treasury. SBA suggested that this provision of the statute should specify the terms and conditions of the transaction; that the government hold a lien position on the assets; and that the transaction be at face value.

H.R. 5019 now clearly spells out that COSBI will pay full face value, in cash, during fiscal year 1987, for SBIC debentures maturing in FY '88 and thereafter. Since this transaction is a sale for cash, and no debt is involved, it would be inappropriate for Treasury to hold a lien position.

3. COSBI Regulation of SBICs - SBA suggested that the bill should clearly spell out all regulatory matters to be included in the COSBI contract governing the business practices of SBICs.

H.R. 5019 has adopted this approach. Virtually all of the significant regulations now in place under SBA have been

codified in the bill. In addition, H.R. 5019 has gone a step further, delineating a more comprehensive framework for regulatory compliance by SBICs under COSBI.

**The Issue of Feasibility** - SBA also questioned the feasibility of COSBI. SBA took the position that, absent the SBA guarantee on SBIC securities, the asset quality of COSBI would be "speculative at best," compared to investment grade securities of other sponsored agencies such as FNMA and SLMA.

SBA's contention is contrary to all of the expert advice provided to the SBIC industry by virtually every major firm in the investment banking community. These experts are convinced that COSBI will be able to issue investment grade securities at attractive yields, and several investment banking firms have gone on record in suppport of this position.

More important, despite SBA's speculation on this point, the SBIC industry, which has an investment over $1 billion at stake, is willing to risk its future on its conviction that COSBI will work.

**Deal Breakers** - The three remaining specific points raised by SBA go to the very heart of the COSBI proposal; they could not be accepted by the industry under any circumstances; and the inclusion of any one of them in the bill would unravel the basic concept of COSBI. Each of these points clearly suggests an effort by SBA to protect its "turf." SBA's posture shows a total disregard for the intent of the legislation, and a failure to consider the implications of its position for the ultimate beneficiaries of the bill - small business.

1. Regulation of SBICs - SBA takes the position that SBA should continue to regulate the SBIC industry as long as any SBIC or MESBIC enjoys any tax advantage as an SBIC or has

any obligation outstanding to, or guaranteed by, SBA.

SBA's position is a misguided attempt to undermine the fundamental concept of privatizing the SBIC industry through COSBI. If SBA continued to directly regulate SBICs, we would be left with a two-track system far more confusing and less efficient than the one currently in place. If the companies in which COSBI invests continued to be subject to the independent regulatory intervention of SBA, COSBI would become a powerless, ineffective financial intermediary, whose financial condition would continually be jeopardized by the whim and fancy of SBA's regulatory actions. Under these circumstances, no sound-thinking SBIC or MESBIC would invest in COSBI's stock or participate in the program; and this type of uncertainty would also destroy COSBI's ability to issue securities in the capital markets.

The regulatory system provided by H.R. 5019 is a far better answer. It is a reasonable approach that provides a responsible role for SBA, protection of the public purposes of the Act and protection of small business. At the same time, it creates an improved operating environment in which SBICs can effectively serve the financial needs of small business, and it provides an arrangement which will allow COSBI to operate effectively in the capital markets.

2. Control of COSBI - SBA also contends that voting control of COSBI should be retained by, and all Directors of COSBI should be appointed by, the Federal Government, as long as COSBI has any obligations outstanding to Treasury, or enjoys the contingent support of Treasury.

This position is simply unacceptable. It reflects a complete lack of understanding of the capital markets, and it would destroy the viability of COSBI.

SBA's position disregards completely the fact that the SBIC investors have over $1 billion of their own private

capital at risk. Moreover, it flies in the face of the industry's commitment to invest $20 million in COSBI's common stock, to purchase the current SBIC portfolio for $1 billion in cash and to take the inherent risk that COSBI will work.

In addition, governmental control over the private operations of a government-sponsored enterprise would be unprecedented. No similar governmental control is exercised over FNMA or SLMA, for example, nor are we aware that any has ever been proposed.

3. Participation of SBICs - SBA objects to the fact that SBICs which elect not to qualify to do business with COSBI will cease being SBICs. SBA indicates that these SBICs should be allowed to continue to operate as SBICs, presumably under SBA's jurisdiction. SBA also asserts that they are aware of many SBICs that do not support COSBI.

SBA's position is rather ironic, since under the Administration's own proposal the total SBIC program would be terminated and all SBICs would lose all their rights. To use SBA's words, "We do not think this is appropriate treatment . . ."

SBA's approach would effectively set up a two-track SBIC system that would undermine the organization and operation of COSBI and defeat the basic purpose of the legislation. Such a system would be ineffective, costly and duplicative; and it would undermine efforts to ensure maximum industry participation in COSBI.

H.R. 5019 has been modified to provide a clear "soft landing" for those SBICs, if any, that decide not to participate in COSBI. The bill now provides a reasonable period of two years for these companies to wind-down their operations.

We believe, however, that COSBI will achieve very close to 100% participation by the SBIC industry. As you know, we have been working on this proposal for over three years. During that time we have communicated extensively with the industry about COSBI, through national and regional meetings as well as written literature. These communications have gone to the total industry, both members and non-members of our respective associations.

Based on that extensive effort, we are not aware of a single SBIC or MESBIC that has voiced an objection to COSBI, or indicated lack of support for the legislation.

To the contrary, we have specifically surveyed the industry in an effort to obtain positive statements of support for COSBI. And, we think the results are amazing for an industry that has a known reputation for not responding to surveys. We solicited "letters of intent" to support COSBI from some 350 active SBICs. Over 200 (60%) of those companies, representing 70% of the industry's total assets, have advised us that they support COSBI. Not one single SBIC has objected to the legislation or indicated they do not support COSBI.

We understand that the Committee's letter to those SBICs and MESBICs who are not members of NASBIC or AAMESBIC has drawn a similar response.

Obviously, we're very encouraged by this overwhelming support from the industry, for it proves that COSBI will work if given the chance.

**Misguided Ideology** - The final point raised by SBA is contained in its letter of January 21, 1986, in which the Administration objects to the COSBI legislation on the basis of a rather extreme interpretation of the concept of "privatization."

The Administration indicates that it would support an effort

to "truly privatize" or "purely privatize" the SBIC program. They go on to define their view of pure privatization as the "total disengagement" of any type of Federal support for the industry. From the Administration's perspective, this would include removal of the backstop, the guaranty of any SBIC debentures, the assets transferred to the MESBIC Trust, tax benefits extended to SBICs, seed money for the MESBIC Trust, securities exemptions for COSBI's securities and any other form of government support, no matter how incidental.

We, of course, regret, and strongly disagree with the extreme, inflexible and totally unworkable position the Administration has taken.

Complete and immediate withdrawal of all forms of government support for this federally created program would destroy the feasibility of COSBI. SBA has raised questions about COSBI's feasibility, even when the Corporation has the incidents of government support provided by H.R. 5019; therefore, how can SBA honestly argue that a "purely private" system with no government support whatsoever would work. While COSBI may be a bridge to eventual privatization as the Administration defines it, we cannot get there in one great leap.

Finally, without wanting to appear too sarcastic, it would seem that the Administration has already made the ultimate proposal for privatization of the SBIC industry on their terms. Their proposal was contained in the President's budget for the past two years, and its called complete elimination of the program. That proposal makes very clear what the Administration means by privatization through "total disengagement."

## CONCLUSION

We believe H.R. 5019 is creative, landmark legislation which will produce enormous rewards for small business and the American economy.

The bill has been substantially improved thanks to the efforts and cooperation of the Chairman, Committee members and Committee staff. We believe H.R. 5019 does the job, and does it well.

We hope the Committee can move expeditiously to mark-up and enactment of the bill by the full House, and we are prepared to support that effort in every way possible.

Thank you, Chairman Mitchell and Congressman McDade, for your leadership and personal involvement in this legislation, which is so critical to the SBIC industry.

Our thanks, as well, to each member of the Committee for your sponsorship and support.

And, our sincere appreciation to the Committee staff for the time and effort they have extended.

I will be pleased to answer any questions.

## COSBI BUDGET SAVINGS ESTIMATE

(Three year period FY '87, '88 and '89)
(Dollars in millions)

| | | |
|---|---|---|
| **Estimated Revenue Increases** | | |
| **Cash purchase of FFB Portfolio** | + 925 | |
| **Savings from unused MESBIC budget authority** | + 129 | |
| **Savings from reduction in SBA operating costs** | + 6 | |
| | | **$ 1060 MILLION** |
| Estimated Revenue Decreases | | |
| Expected principal repayments of SBIC debentures | - 163 | |
| Expected interest payments on SBIC debentures | - 233 | |
| Expected principal repayments of MESBIC debentures | - 20 | |
| Expected interest and dividends from MESBIC securities | - 24 | |
| Financing the MESBIC Trust | - 100 | |
| | | - 540 |
| **Estimated Net Savings** | | **$ 520 MILLION** |
| **Interest realized from investment of cash proceeds** | | + 214 |
| **ESTIMATED TOTAL SAVINGS** | | **$ 734 MILLION** |

## COSBI BUDGET SAVINGS ESTIMATE -- ANNUALIZED

(Dollars in millions)

| | 1987 | 1988 | 1989 |
|---|---|---|---|
| **Estimated Revenue Increases** | | | |
| **Cash purchase of FFB Portfolio** | + 925 | 0 | 0 |
| **Savings from unused MESBIC budget authority** | + 41 | + 43 | + 45 |
| **Savings from reduction in SBA operating costs** | + 2 | + 2 | + 2 |
| Estimated Revenue Decreases | | | |
| Expected principal repayments of SBIC debentures | 0 | - 85 | - 78 |
| Expected interest payments on SBIC debentures | - 78 | - 81 | - 74 |
| Expected principal payments of MESBIC debentures | - 6 | - 7 | - 7 |
| Expected interest and dividends from MESBIC securities | - 8 | - 8 | - 8 |
| Financing the MESBIC Trust | - 100 | 0 | 0 |
| **Estimated Net Savings** | + 776 | - 136 | - 120 |
| **Interest realized from investment of cash proceeds** | + 66 | + 71 | + 77 |
| **ESTIMATED TOTAL SAVINGS** | + 842 | - 65 | - 43 |

Mr. MITCHELL. Thank you. Thank both of you gentlemen for very, very excellent testimony. Just excellent.

One comment from me, that is on SBA regulatory control. I do not see the need for SBA to exercise control over anything other than COSBI. I think if you start that business you are going to find uncertainties, delays, and everything else if you start auditing the companies themselves.

I do not know what SBA's final position was on this. They still want to go into and regulate the SBIC's. I think that is wrong. One of the reasons behind this legislation is to avoid the kind of slowdowns and uncertainties, et cetera, that we have experienced over the last some 5 years, maybe a little more, with the industry. I think you simply prolong that type of difficulty by any attempt to audit or any attempt to regulate the individual SBIC's. I think you regulate the large entity. I feel very strongly on that.

I was glad, Mr. Noojin, to hear you talk about the companies that have not indicated a willingness to participate but that you think might because, quite frankly, that is one of the elements that worries me just a little bit about this legislation. What happens to the guys that do not want to join? We really do not have any end plan prepared for them. They just close their doors.

My hope would be that all of them would join, but it certainly does represent a small troublesome area for me.

I really do not have any questions. I just wanted to make those observations.

Mr. McMillan.

Mr. MCMILLAN. Let me just pick up on what you were just inquiring about. Of the hundred—I think you said 105 of 308, is that correct, have indicated an interest in joining?

Mr. NOOJIN. Yes, sir.

Mr. MCMILLAN. What does that——

Mr. NOOJIN. No. No; all but 108.

Mr. MCMILLAN. All but 105.

Mr. NOOJIN. Yes, sir.

Mr. MCMILLAN. OK. So almost two-thirds.

In terms of the assets represented by those two-thirds do they tend to——

Mr. NOOJIN. Over 90 percent.

Mr. MCMILLAN. Maybe that is a more significant figure than the other, I would think.

Mr. MITCHELL. Yes.

Mr. MCMILLAN. One other point that was raised a little earlier had to do with tax reform and its impact on SBIC's. And I think the easy answer is to say, well, if we raise the capital gains rate it is going to be a disincentive for capital investment. And I think that is true up to a point. And I happen to believe it will also produce less tax revenue for the country, Government, but that is another issue.

But I think there are a lot of other things in tax reform. Because basically, what is behind a lot of the elimination of incentives for this and that kind of investment is an elevation of the incentive for what have been the more traditional modes of investing in the equities or securities of growing companies. So I think with the reduction of incentives for tax shelters, so to speak, there is going to

be a shift of capital into a more traditional mode of investment. And I consider this to be a very traditional mode of investment.

You know, if you went and looked at the 500 largest companies in the United States today you would not have to go back very long in time before they would have been qualified to receive SBIC financing. And I think it would be rather impressive to do that. And they were formed largely by venture capital. And I consider SBIC's to be a form of venture capital but focused on certain size.

I have been in the investment business as an investment banker raising capital for all kinds of companies as part of a venture capital firm that did not operate as an SBIC licensee, and as an SBIC licensee in another situation. And each of those meet very different capital needs.

I am really excited about the prospects of this legislation, not just from the standpoint of relieving the Government of a cost that we year after year debate, but rather as opening up for even greater potential the formation of venture capital to small business in this country. I agree with you, I think it is going to mean at least locking in the Government's exposure and, over time, reducing the outlays required to support it, replacing that with private outlays. I think it has a tremendous, a tremendous chance to succeed, and something that we, for that reason, should support wholeheartedly.

I am not going—I perhaps have a few more questions on that issue of what is it actually costing us to make this change? But I do not want to belabor that at this point. I would suggest that it might be worth looking at on a pure outlay or cash basis in contrast to other numbers in terms of getting into valuation issues and that sort of thing, because securities held by the Government producing low rate of income are, in real economic terms, not worth what they are carried at. What we are concerned about, I think, in the budgetary aspects of this is what does it mean in current outlays? I am going to come back and look at that. I do not want to question—raise a question on that at this point.

And I think perhaps that is all I have got at this point. I would yield back.

Mr. MITCHELL. You gave it to me, and I should remember it, but under your 50-year minority trust provision what amount would you anticipate on an annual basis of debentures and stock purchases? Is it on that chart? And I cannot quite see the chart. But I think you gave me that figure.

Mr. HILL. Yes; I apologize for the size of the numbers, sir.

Mr. MITCHELL. No; that is all right.

Mr. HILL. I understand that the chart maker wore bifocals and the numbers looked a little bigger to him than they actually are. So that may be the reason.

[Laughter.]

Mr. HILL. But in any event, the debentures during the first year would be $20 million. That would increase at roughly 8 percent per year.

In the case of the preferred stock, the first year would be $20 million. And that actually declines by about 4 percent a year which results in a 3- to 4-percent increase in the actual leverage, new leverage available to the MESBIC's each year.

Mr. MITCHELL. Just one last comment, and that is to my friend Herb with whom I have worked throughout the years. You have been a mighty strong guide in support of many of the activities that we have tried to carry on for minority businesses. I know we added a few gray hairs to your head with regard to the trust fund, but there was no other way to do it.

I just wanted to single you out in addition to the other gentleman as really giving more than yeoman service to produce this legislation.

We will move to a subcommittee markup as expeditiously as possible. Hopefully, then on to full committee markup and maybe sail it down to the President's desk, I do not know. No; it will not move quite in that fashion.

Gentlemen, thank you. Thank you very much for being with us this morning.

Mr. HILL. Thank you, Mr. Chairman.

Mr. NOOJIN. Thank you, Mr. Chairman.

Mr. MITCHELL. This hearing is now adjourned.

[Whereupon, at 11:13 a.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

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